Harvard Roundtable on Corporate Governance

March 14–15, 2018

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Tab I: The Coming Proxy Season

An Overview of U.S. Shareholder Proposal Filings

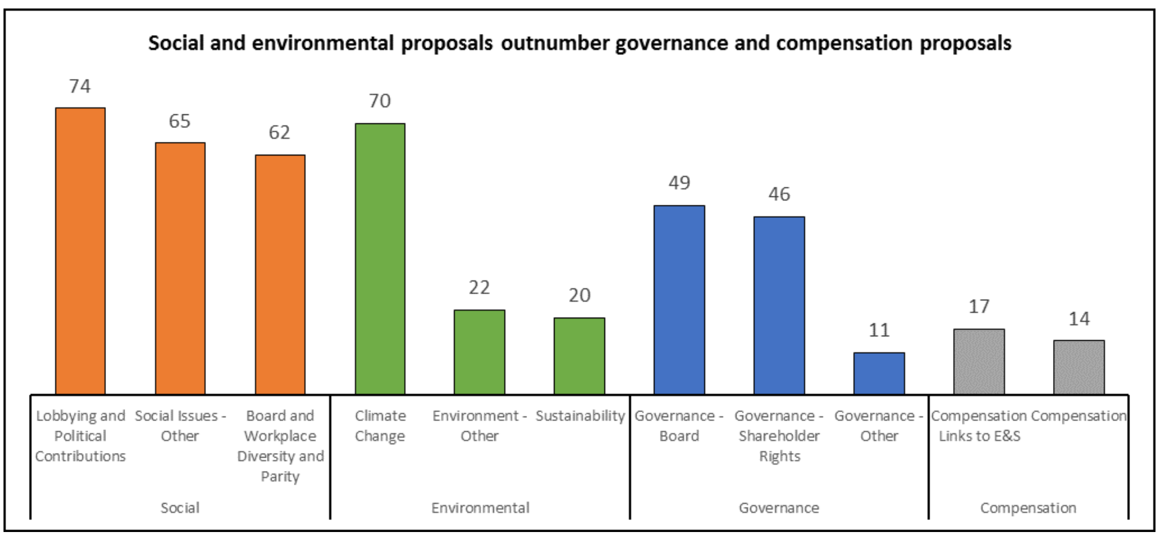
Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Wednesday, February 28, 2018

Editor's note: Subodh Mishra is Executive Director at Institutional Shareholder Services, Inc. This post is based on an ISS Analytics publication by Kosmas Papadopoulos, Managing Editor at ISS Analytics.

The 2018 U.S. proxy season is around the corner, and an early overview of shareholder proposal filings may give us a first taste of what is in store for investors and companies in terms of hot-button issues and overall market dynamics. Based on our analysis of shareholder proposal filings available in ISS' shareholder filings database, we identified 450 proposals filed at Russell 3000 companies, of which 334 are still pending, while the rest have already made on ballots or were omitted and withdrawn.

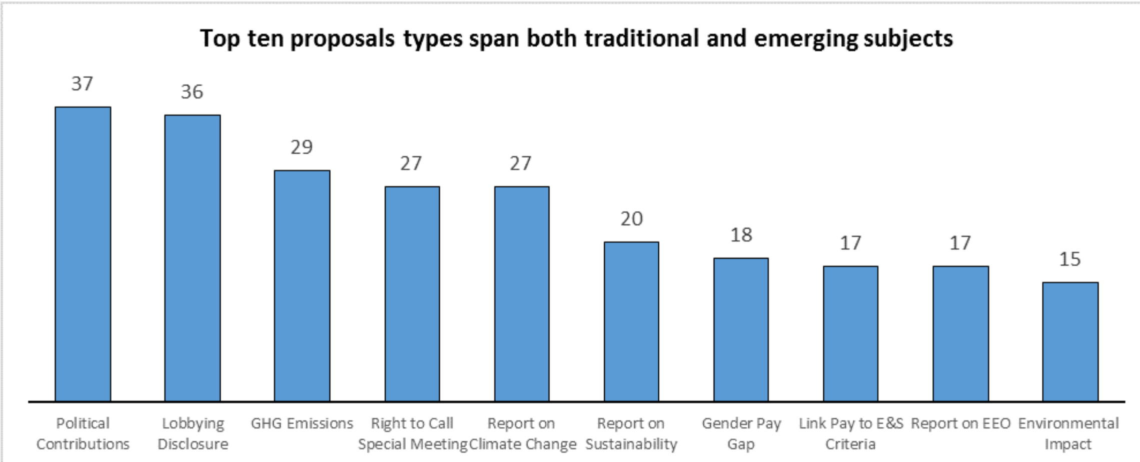
Environmental and social issues dominate the agenda

This year promises to continue the recent trend of social and environmental issues overshadowing governance- and compensation-related proposals. More than two-thirds of filed proposals are related to social or environmental issues, with political spending and actions, board and workplace diversity and parity and climate and sustainability being the key themes.



Source: ISS Analytics

A closer look at proposal types and issue-specific campaigns makes the point clearer. Nine of the ten most commonly filed proposal types relate to environmental or social issues, while only one pertains to a governance concern.



Source: ISS Analytics

There may be a twofold explanation regarding this shift towards more environmental and social shareholder proposal filings and fewer governance proposals. First, social and environmental issues themselves are gaining significant traction with investors and the public. Important issues, such as concerns about the transparency of the political process, harassment and equity in the workplace, and climate change risks make headlines and dominate the public discussion daily. At the same time, investors and asset owners are bolstering their efforts towards greater ESG integration, which helps proponents gain further momentum. Second, governance topics may be lower on the agenda for the target universe. Shareholder proposals are typically filed at large-capitalization companies, where many formerly-contested governance issues have now become the standard. Annual director elections, majority vote standard, simple majority vote requirements and even proxy access—to a large extent—are now the norm for the vast majority of large companies. While, some proponents move on to the next tier of smaller-size companies to address governance concerns, those efforts are less likely to gain as much attention or make an impact to the broader market compared to proposals filed at large firms. Therefore, proponents may be forced to make a strategic decisions to continue to focus on large companies, which often serve as models for the rest of the market.

Among voted proposals, for which vote results are available, several have received significant support. The list below of proposal with highest support rates thus far in 2018 indicates that the types of proposals with high support levels may vary considerably, as not one issue seems to prevail.

Company Name	Proposal	For/F+A (%)
Costco Wholesale Corp	Adopt Simple Majority Vote	86.8
ACUITY BRANDS, INC.	Report on Sustainability, Including GHG Emissions	49.8
Emerson Electric Co.	Require Independent Board Chairman	46.2
Sanderson Farms, Inc.	Require Independent Board Chairman	44.9
Sanderson Farms, Inc.	Phase Out Use of Antibiotics For Disease Prevention	43.1
Emerson Electric Co.	Report on Lobbying Payments and Policy	39.6
Emerson Electric Co.	Report on Political Contributions	39.4
Emerson Electric Co.	Adopt Company-Wide GHG Emissions Reduction Goals	39
Walgreens Boots Alliance	Reduce Ownership Threshold – Right to Call Special Meeting	36.8
Apple Inc.	Amend Proxy Access Right	32.2

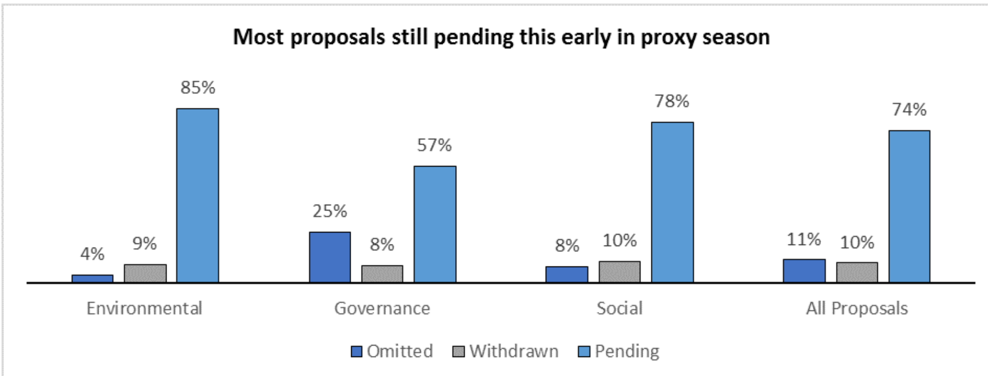
Source: ISS Voting Analytics

Opioid accountability campaign

A notable new proposal type concerns a campaign launched by Investors for Opioid Accountability (IOA), a coalition of 30 treasurers, asset managers, faith-based, public and labor funds with more than $1.3 trillion in assets. The proposals are directed at pharmaceutical and prescription drug distribution companies, and seek for reporting on the monitoring and management of financial and reputational risks related to the opioid crisis in the United States. The supporting statement for the proposal filed at AmerisourceBergen Corporation (meeting date 03/01/2018) cites a $16 million settlement with the state of West Virginia over claims of potentially negligent distribution of controlled substances to pharmacies that serve individuals who abuse opioids and failure to report suspicious orders according to state regulations. The proposal requests better transparency regarding governance measures to address such risks, including board and committee oversight as well as executive compensation incentives to promote ethical conduct in relation to opioid-related distributions. IOA has filed ten such proposals at U.S. companies so far in 2018.

A significant portion of proposals challenged at the SEC

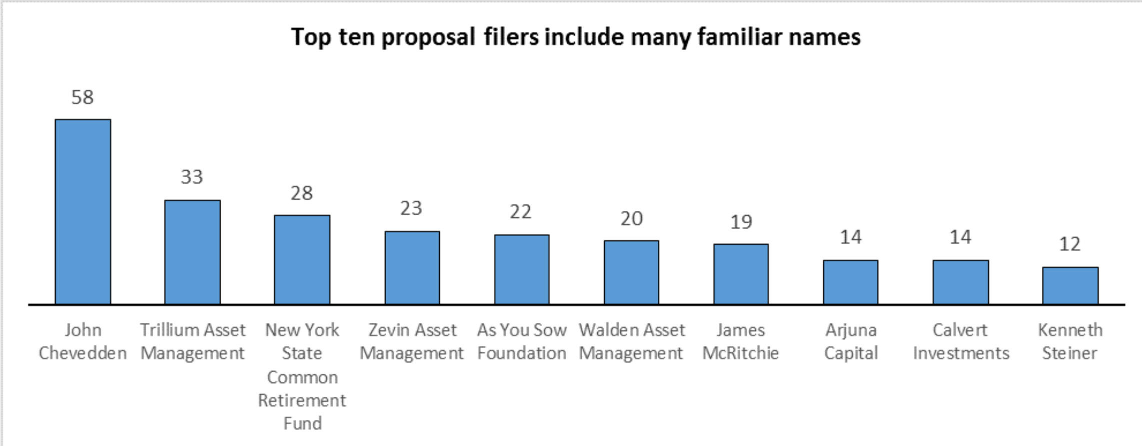
More than 40% of proposals filed in the ISS database were challenged at the SEC. For the full calendar year 2017, that figure stood at approximately 30% of filed proposals. While it may be too early to draw conclusions about trends, shareholders will follow resolution challenges closely. As the SEC has a full slate of commissioners after almost two years, and the administration has indicated its willingness to reform the shareholder proposal process, the SEC's responses to shareholder proposal challenges gains further significance. As of today, 50 of the 450 proposals were omitted, while 43 were withdrawn.



Source: ISS Analytics

Proponents with variety of perspectives and some specialization

A look at the top proposal filers features many familiar names, including individuals, asset managers and asset owners. The top three filers demonstrate how there is some level of specialization among filers, while there are also very different perspectives among them. John Chevedden, who currently tops the list, has focused his efforts on governance-related items, and he may be responsible for the majority of governance proposals filed this year, including a large number dealing with the right to call a special meeting. Trillium Asset Management, on the other hand, primarily focused on board and workplace diversity and climate change. Meanwhile, the majority of proposals filed by the New York State Common Retirement Fund pertained to political contributions and lobbying disclosure.



Source: ISS Analytics

As the landscape of shareholder resolution filings continues to take shape, investors and companies will pay attention to developments in filing and voting trends. It seems certain that, even amidst an uncertain regulatory environment, shareholder resolution filings continue to play a major role in shaping the agenda for stewardship priorities in the market.

Tab II: Board Oversight

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

Statement on Cybersecurity Interpretive Guidance

Posted by Jay Clayton, U.S. Securities and Exchange Commission, on Thursday, February 22, 2018

Editor's note: Jay Clayton is Chairman of the U.S. Securities and Exchange Commission. This post is based on Chairman Clayton's recent remarks concerning the SEC Cybersecurity Interpretive Guidance, available here. The views expressed in this post are those of Mr. Clayton and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Yesterday [Feb. 20, 2018], the Commission approved the issuance of an interpretive release to provide guidance to public companies when preparing disclosures about cybersecurity risks and incidents. The release also communicates the Commission's views on the importance of maintaining comprehensive policies and procedures related to cybersecurity risks and incidents.

In today's environment, cybersecurity is critical to the operations of companies and our markets. Companies increasingly rely on and are exposed to digital technology as they conduct their business operations and engage with their customers, business partners, and other constituencies. This reliance on and exposure to our digitally-connected world presents ongoing risks and threats of cybersecurity incidents for all companies, including public companies regulated by the Commission. Public companies must stay focused on these issues and take all required action to inform investors about material cybersecurity risks and incidents in a timely fashion.

In 2011, the Division of Corporation Finance issued guidance that provided the Division's views regarding disclosure obligations that relate to cybersecurity risks and incidents. Yesterday, the Commission voted to provide guidance to public companies that reinforces and expands the Division's prior guidance. The guidance highlights the disclosure requirements under the federal securities laws that public operating companies must pay particular attention to when considering their disclosure obligations with respect to cybersecurity risks and incidents. It also addresses the importance of policies and procedures related to disclosure controls and procedures, insider trading, and selective disclosures. I believe that providing the Commission's views on these matters will promote clearer and more robust disclosure by companies about cybersecurity risks and incidents, resulting in more complete information being available to investors. In particular, I urge public companies to examine their controls and procedures, with not only their securities law disclosure obligations in mind, but also reputational considerations around sales of securities by executives.

There is no doubt that the cybersecurity landscape and the risks associated with it continue to evolve. I have asked the Division of Corporation Finance to continue to carefully monitor cybersecurity disclosures as part of their selective filing reviews. We will continue to evaluate developments in this area and consider feedback about whether any further guidance or rules are needed.

Public Company Cybersecurity Disclosures

Posted by Kara M. Stein, U.S. Securities and Exchange Commission, on Friday, February 23, 2018

Editor's note: Kara M. Stein is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Stein's recent public statement, available here. The views expressed in the post are those of Commissioner Stein and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

Yesterday [February 20, 2018], the Commission attempted to tackle an increasingly important issue: How should a public company tell its investors about its cybersecurity risks and incidents?[1]

Undeniably, the high-profile data losses and security breaches that have occurred across the public and private sectors show that no company or organization is immune from cyberattack. Unfortunately, one only need look back to the past eight years to see example after example of these attacks. In 2010, a sophisticated cyberattack affected more than 75,000 computer systems at nearly 2,500 companies in the United States and around the world.[2] In 2014, hackers broke into the computer systems of a major Hollywood studio, stealing confidential documents and exposing these documents and other personal information to potential cybercriminals.[3] And last year, we learned that a major cybersecurity breach at a public company may have potentially affected half of the U.S. population.[4] When the magnitude of the breach was revealed publicly, the company's stock price plummeted, losing over $5 billion in market value.[5]

Unfortunately, the risks and costs of cyberattacks appear to be growing. And the consequences of such attacks could have devastating and long-lasting collateral effects. Cybercriminals are only becoming more cunning and sophisticated. It is estimated that cybercrime will cost businesses approximately $6 trillion per year on average through 2021.[6] Globally, the average cost of

[1] As we all know, fundamental to the federal securities laws is the principle that public companies disclose information to allow investors to make informed investment decisions. This means that public companies must disclose, among other things, risks and events that a reasonable investor would consider important. And depending on the company and its particular facts and circumstances, this could mean disclosure relating to cyber risks.

[2] *See* Ellen Nakashima, "More than 75,000 computer systems hacked in one of largest cyberattacks, security firm says," *The Washington Post* (Feb. 18, 2010), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/02/17/AR2010021705816.html.

[3] *See* Andrea Peterson, "The Sony Pictures hack, explained," *The Washington Post* (Dec. 18, 2014), *available at* https://www.washingtonpost.com/news/the-switch/wp/2014/12/18/the-sony-pictures-hack-explained/?utm_term=.5b8531b2bf8f .

[4] *See* Victor Reklaitis, "Equifax's stock has fallen 31% since breach disclosure, erasing $5 billion in market cap," *MarketWatch* (Sept. 14, 2017), *available at* https://www.marketwatch.com/story/equifaxs-stock-has-fallen-31-since-breach-disclosure-erasing-5-billion-in-market-cap-2017-09-14.

[5] *Id.*

[6] *See* Nick Eubanks, "The True Cost Of Cybercrime For Businesses," *Forbes* (Jul. 13, 2017), *available at* https://www.forbes.com/sites/theyec/2017/07/13/the-true-cost-of-cybercrime-for-businesses/#6c0453c44947

cybercrime has increased 62% over the last five years.[7] In addition, the cost of unintentional data loss—the most expensive component of a cyberattack—has risen nearly ten percent over the last three years alone.[8] Not surprisingly, public companies, investors, and other market participants increasingly view confronting and mitigating cyberrisk as a major priority.

So, what has the Commission done in response? In 2011, the staff of the Division of Corporation Finance attempted to address cyberrisks from a disclosure perspective. The staff issued disclosure guidance that discussed how public companies should disclose cyberrisks and their related impact within the existing disclosure framework.[9]

Unfortunately, despite the staff's best efforts to develop guidance that elicits robust disclosure to investors, meaningful disclosure has remained elusive. In fact, a 2014 study noted that the staff guidance "resulted in a series of disclosures that rarely provide differentiated or actionable information for investors."[10] That same year, the Commission hosted a roundtable at in order to discuss the cybersecurity issues faced by various market participants, including public companies.[11] As one participant pointed out during the roundtable, a public company's disclosures are supposed to allow investors to understand a company's particular risks to better determine how a company's risk profile may differ from another company's risk profile.[12] Nevertheless, other roundtable participants observed that public company disclosures regarding cybersecurity risks and incidents were far from robust and, instead, largely consisted of boilerplate language that failed to provide meaningful information for investors.[13] Just a few months ago, the SEC's Investor Advisory Committee noted that public company disclosures regarding cybersecurity risks and incidents have not improved.[14] This is the case despite the very real increase in the number and sophistication of, and damaged caused by, cyberattacks on public companies in recent years. Members of Congress also have repeatedly called for the Commission do to more to help public companies, investors, and other market participants address cyberrisks.[15]

And so, when the Chairman put cybersecurity on the Commission's agenda, I was very supportive. Unfortunately, I am disappointed with the Commission's limited action.

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[7] *See* Cost of Cyber Crime Study: Insights on the Security Investments That Make a Difference, Accenture (2017), *available at* https://www.accenture.com/t00010101T000000Z__w__/fr-fr/_acnmedia/PDF-62/Accenture-2017CostCybercrime-US-FINAL.pdf.

[8] *See* Path to cyber resilience: Sense, resist, react, EY's 19th Global Information Security Survey 2016-17, Ernst & Young LLP, *available at* http://www.ey.com/Publication/vwLUAssets/ey-global-information-security-survey-2016-pdf/%24FILE/GISS_2016_Report_Final.pdf.

[9] CF Disclosure Guidance: Topic No. 2, Cybersecurity, Division of Corporation Finance (Oct. 13, 2011), *available at* https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[10] *See* What investors need to know about cybersecurity: How to evaluate investment risks, Investor Responsibility Research Center Institute (Jun. 2014), *available at* https://irrcinstitute.org/wp-content/uploads/2015/09/cybersecurity-july-20141.pdf.

[11] *See* Cybersecurity Roundtable, U.S. Securities and Exchange Commission (Mar. 26, 2014), *available at* https://www.sec.gov/spotlight/cybersecurity-roundtable.shtml.

[12] *See* Transcript, Cybersecurity Roundtable, U.S. Securities and Exchange Commission (Mar. 26, 2014), *available at* https://www.sec.gov/spotlight/cybersecurity-roundtable/cybersecurity-roundtable-transcript.txt.

[13] *Id.*

[14] *See* "Discussion Draft Re: Cybersecurity and Risk Disclosure," Investor as Owner Subcommittee, SEC Investor Advisory Committee (Dec. 2017) ("IAC Discussion Draft"), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/discussion-draft-cybersecurity-disclosure-iac-120717.pdf.

[15] *See, e.g.*, Letter from Congressmen Jim Langevin and Jim Himes, Members, Committee on Homeland Security, Cybersecurity, Infrastructure Protection, and Security Technologies, to Mary Jo White, Chair, U.S. Securities and Exchange Commission (Jun. 17, 2015), *available at* http://langevin.house.gov/sites/langevin.house.gov/files/documents/06-17-15_Langevin_Himes_Letter_to_SEC.pdf.

Yesterday, the Commission issued interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents. This guidance reminds companies that they should consider cybersecurity risks and incidents when preparing documents that they file with the Commission, as the federal securities laws require them to disclose information about material cybersecurity risks and incidents. As this guidance describes, disclosure may be required in the context of a public company's existing reporting obligations—such as the company's risk factors, management's discussion and analysis, or financial statements. This guidance also reminds companies of the importance of maintaining comprehensive policies and procedures—including effective disclosure controls and procedures—that address cybersecurity risks and incidents. In addition, it reminds company insiders that trading securities while in possession of non-public information about cybersecurity incidents may violate the federal securities laws.

To be sure, these are all valuable reminders and raising them to the Commission level indicates a level of significance the staff guidance from seven years ago simply does not. The problem, however, is that many of these reminders were offered by the staff back in 2011. If our staff has already provided guidance regarding cyber-related disclosures, the question, then, is what we, as the Commission, should be doing to add value given seven additional years of insight and experience. Should we be, in effect, re-issuing staff guidance solely to lend it a Commission imprimatur? Will companies, their general counsels, and their boards suddenly take notice of their cyber-related disclosure obligations because of the Commission's new endorsement? Or will law firms simply produce a host of client alerts reaffirming their alerts from years past?

These questions serve to demonstrate only part of the problem. The more significant question is whether this rebranded guidance will actually help companies provide investors with comprehensive, particularized, and meaningful disclosure about cybersecurity risks and incidents. I fear it will not.

I would like to highlight just a few examples of what we could have achieved in the context of disclosure:

- We could have examined what the staff has learned since the release of its 2011 guidance and provided new guidance that capitalized on these findings. After all, the staff of the Division of Corporation Finance reviews hundreds of public company filings every year. The staff also reviews hundreds of shareholder proposals each year, many of which have been increasingly calling on companies to provide more effective cyber-related disclosure.
- We could have discussed the various advances in technology used in cyberattacks since 2011, and how such advances could affect a company's disclosure regarding company-specific risks.
- We could have considered the suggestions from some of our leading commenters, including academics and practitioners. We could have, for example, considered some of the recent Investor Advisory Committee Subcommittee's preliminary suggestions,[16] and discussed the value to investors of disclosure relating to:
    - a company's protocols relating to, or efforts to minimize, cybersecurity risks and its capacity, and any measures taken, to respond to cybersecurity incidents;
    - whether a particular cybersecurity incident is likely to occur or recur; or

[16] *See* IAC Discussion Draft.

- how a company is prioritizing cybersecurity risks, incidents, and defense.
- We could have discussed the value to investors of disclosure regarding whether any member of a company's board of directors has experience, education, expertise, or familiarity with cybersecurity matters or risks. And, if not, why the company believes that board-level resources are not necessary for the company to adequately manage its cybersecurity risks.

The list goes on. In effect, we could have helped companies formulate more meaningful disclosure for investors. Instead, yesterday's guidance provides only modest changes to the 2011 staff guidance.

Some would say that the Commission is confined in what it can do in the context of guidance, without engaging in a formal rulemaking. I agree. I believe it is important for the Commission to be mindful of the guidance it or its staff produces that may be tantamount to rulemaking.[17]

That is why, as I have remarked before, it is imperative that the Commission do more.[18] As we have heard from a variety of commenters since the 2011 staff guidance, guidance, alone, is plainly not enough. This makes it all the more confusing that the Commission more or less reissued that very guidance. Simply put, seven years since the staff guidance was released, despite dramatic increases in cyberattacks and their related costs, there have been almost imperceptible changes in companies' disclosures. This to me strongly suggests that guidance alone is inadequate.

Yet, the Commission has ignored pleas from issuers, investors, market participants, and members of Congress to do more. And we could have done so much more. For example:

- We could have sought notice and comment on proposed rules that address improvements to the board's risk management framework related to cyberrisks and threats. Too many companies currently fail to consider cybersecurity as a business risk and, thus, do not incorporate it within the risk management framework overseen by their boards. These proposed rules could address current weaknesses in the nature, timing, and extent of disclosure to investors.
- We could have sought notice and comment on whether the Commission should establish minimum standards to protect the personally identifiable information of investors and whether such standards should be required for key market participants, such as broker-dealers, investment advisers, and transfer agents.[19]
- We could have sought notice and comment on proposed rules that would require a public company to provide notice to investors (*g.*, a Current Report on Form 8-K) in an appropriate time frame following a cyberattack and to provide disclosure that is useful to investors, without harming the company competitively.

[17] *See, e.g.*, Commissioner Kara M. Stein, Statement on the Staff's No-Action Relief Regarding MiFID II (Oct. 26, 2017), *available at* https://www.sec.gov/news/public-statement/statement-stein-2017-10-26.

[18] *See* Commissioner Kara M. Stein, "Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance," Remarks at Stanford University (Feb. 13, 2018), *available at* https://www.sec.gov/news/speech/speech-stein-021318 (discussed on the Forum here).

[19] *See* Chair Mary Jo White, Statement at Open Meeting on Regulation SCI (Nov. 19, 2014), *available at* https://www.sec.gov/news/public-statement/spch112014mjw ("I have directed the staff to prepare recommendations for the Commission's consideration as to whether an SCI-like framework should be developed for other key market participants, such as broker-dealers and transfer agents.")

- We could have sought notice and comment on whether the Commission should issue rules that are more programmatic and that would require a public company to develop and implement cybersecurity-related policies and procedures beyond just disclosure.

I recognize that in our current Digital Age, these matters are complicated. But this cannot be the reason we do not engage. We should proceed, and engage investors, market participants, and pubic companies through notice and comment rulemaking in order to get their best thoughts.[20]

In conclusion, it is hard to disagree with the Commission emphasizing the importance of the disclosure of cybersecurity risks and incidents. As a result, I supported the Commission's guidance, but not without reservation. While it may have the potential of providing both companies and investors with incremental benefit, the guidance does not sufficiently advance the ball—even in the context of disclosure guidance. Even more, it may provide investors a false sense of comfort that we, at the Commission, have done something more than we have.

Ultimately, the step the Commission took with respect to cybersecurity risks and incidents should only be its first. There is so much more we can and should do. I hope we will proceed accordingly for the good of investors, public companies, and our capital markets.

[20] *See* Steven T. Mnuchin & Craig S. Phillips, U.S. Dep't of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets 219 (Oct. 2017), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("Treasury recommends that the CFTC and the SEC take steps to ensure that guidance is not being used excessively or unjustifiably to make substantive changes to rules without going through the notice and comment process.").

Harvard Law School Forum on
Corporate Governance and Financial Regulation
SUPPORTED BY: pwc

Critical Update Needed: Cybersecurity Expertise in the Boardroom

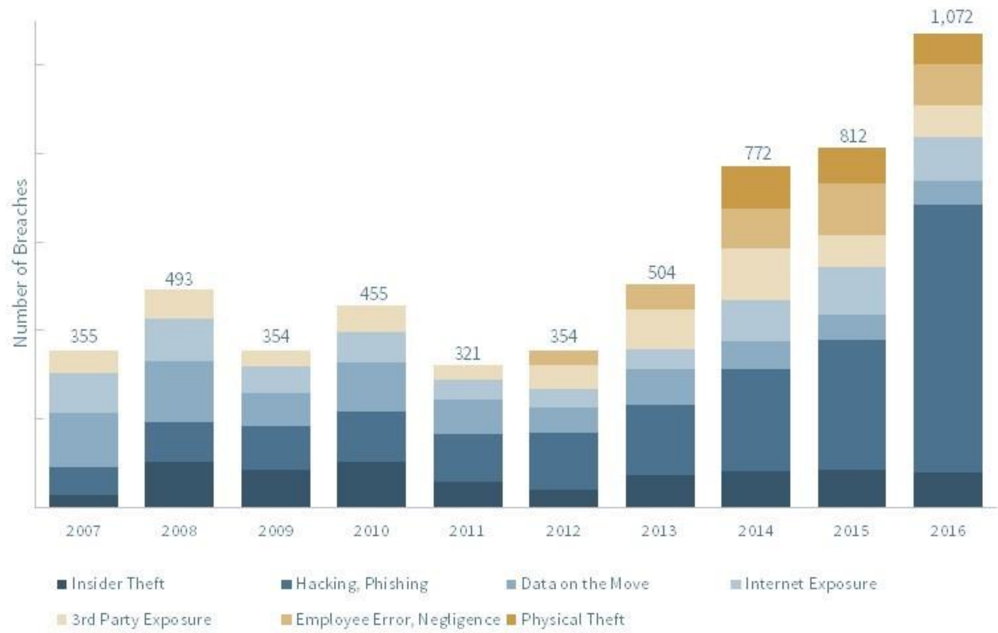
Posted by David F. Larcker, Peter C. Reiss, and Brian Tayan (Stanford University), on Tuesday, December 12, 2017

Editor's note: David F. Larcker is James Irvin Miller Professor of Accounting, Peter C. Reiss is MBA Class of 1963 Professor of Economics, and Brian Tayan is a Researcher with the Corporate Governance Research Initiative at Stanford Graduate School of Business. This post is based on their recent paper.

We recently published a paper on SSRN, Critical Update Needed: Cybersecurity Expertise in the Boardroom, that evaluates the quality of information presented by management to directors in advance of board meetings. Below is a reproduction of the text.

As part of its oversight responsibilities, the board of directors is expected to ensure that management has identified and developed processes to mitigate risks facing the organization, including risks arising from data theft and the loss of proprietary or customer information. Unfortunately, general observation suggests that companies are not doing a sufficient job of securing this data. Data theft has grown considerably over the last decade. According to the Identity Theft Resource Center, the number of data breaches tripled from 2007 to 2016. The main contributor to this increase was theft by third-party hacking, skimming, and phishing schemes (see Exhibit 1).

Exhibit 1: Data Breaches by Category



Data breach is defined as an incident in which an individual name plus Social security number, driver's license number, medical record, or financial record (including credit or debit card numbers) is potentially at risk because of exposure.

Source: Identity Theft Resource Center (ITRC).

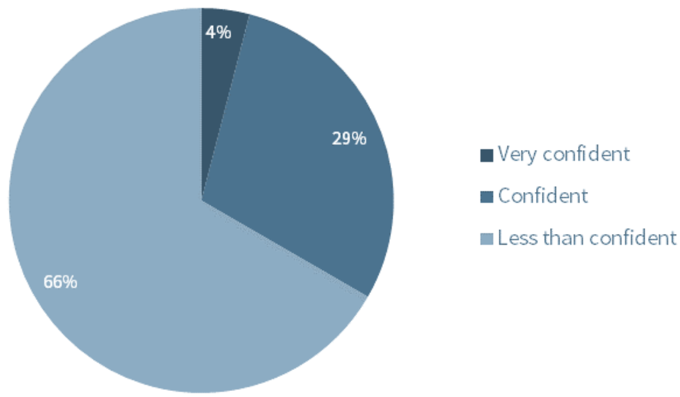
The cost of data theft is significant. According to the Ponemon Institute, the average direct organizational cost of a data breach in the United States is $7 million. This includes the cost to identify and contain the breach, notify customers, and loss of business. Class-action lawsuits add to this figure, with settlements ranging from approximately $1 million for moderate-scale data breaches to over $100 million for large-scale breaches. One study finds that the average stock declines 5 percent following the disclosure of a breach and performs negatively over the subsequent 90-day period. Clearly, cybersecurity is an important risk facing companies and their shareholders.

Incidents of Data Theft

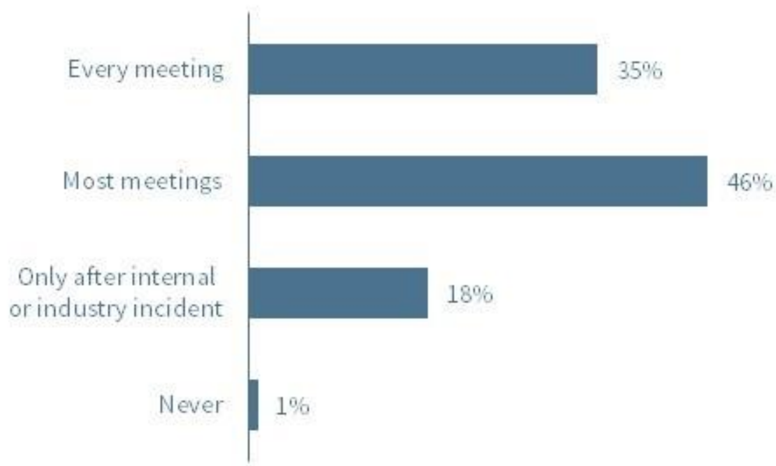
Given the cost and likelihood of a successful cyberattack, it is important to ask whether boards and management have sufficient understanding and are appropriately prepared to prevent, monitor, and mitigate digital data theft (see Exhibit 2 for survey data). To shed light on this question, we reviewed prominent incidents of data theft over the last five years to understand the types of cyberattacks that occur and how companies respond to them.

Exhibit 2: Survey Data: Board of Directors on Cybersecurity

"How confident are you that your companies are properly secured against cyberattacks?"



"How often are cybersecurity matters discussed during board meetings?"



Sample includes approximately 200 directors of public companies.

Source: Veracode and New York Stock Exchange, "A 2015 Survey: Cybersecurity in the Boardroom," (2015)

Customer Data. Payment and accounting system breaches are an important source of cyber risk. One of the largest attacks on a payment network occurred at Target in December 2013 when over 40 million accounts were compromised in a system-wide breach over a three-week period during the holiday shopping season. This attack was followed by several high-profile payment-system breaches at the Home Depot, Michaels Stores, Neiman Marcus, Supervalu, and Staples, as well as franchised owners of UPS Stores, PF Chang's, and Hard Rock Café. The frequency of credit card breaches has been significantly reduced through chip-card requirements introduced by the major payment networks in 2016; however, they remain an important point of vulnerability.

Another type of data theft involves penetrating corporate networks or employee devices that store the personal information of clients and employees. This information is then sold in anonymous "dark" markets on the web. Recent examples of personal data theft include Morgan Stanley, Scottrade, and Standard Charter, where hackers or internal employees download the personal information of wealth-management clients, including names, account numbers, and investments. Similarly, health insurance networks such as Anthem, Primera, and CareFirst BlueCross have been targeted by cybercriminals who steal the names, birthdays, addresses, social security numbers and health information of customers. One of the largest breaches of personal data occurred in September 2017 when the credit-reporting firm Equifax reported that personal information on 143 million customers was exposed.

A more unusual example of personal data theft occurred in September 2014 when hackers accessed the Apple iCloud data storage accounts of targeted celebrities, such as actresses Jennifer Lawrence and Kirsten Dunst and model Kate Upton, and stole their personal photos and videos, some of which were released publicly. The individual responsible for hacking these accounts was sentenced to 18 months in prison. To improve security, Apple introduced technology to provide automatic email notification when an iCloud account is accessed from a new device or browser.

Corporate Systems and Data. Customer data is not the sole target of cybercriminals. In 2014, the North Korean government attacked Sony Picture's IT infrastructure in an attempt to intimidate the company into not releasing a comedy film titled *The Interview*, which featured a fictional plot to assassinate North Korea's real leader. Hackers inserted a malware program, which wiped out half of the company's computers and servers with a sophisticated algorithm that made data recovery nearly impossible. Sony withheld release of the movie from most theaters but later made it available on demand and in select locations. Similarly, in 2017, rumors circulated that hackers had infiltrated Disney Studios and stole a copy of a forthcoming sequel to the movie *Pirates of the Caribbean*. Reports alleged that the hackers demanded "an enormous amount of money" in Bitcoin in order not to release the firm. Disney, in cooperation with the FBI, eventually determined that the hack had not been successful.

Company products also are subject to cyber threats when hackers access and assume control over products. The variety of products vulnerable to such attacks is remarkably broad. For example, in 2015 Fiat Chrysler recalled 1.4 million Jeep vehicles after it was determined that a cybersecurity flaw allowed hackers to remotely assume control of the car through wireless communication systems. The company had been aware of the security flaw but issued the recall when it discovered that hackers could remotely control the car's brakes, transmission, and other electronics. In 2016, a short-selling research firm released a report that cardiac implants produced by medical device company St. Jude Medical were vulnerable to cyberattack. A third party confirmed that in proprietary testing it was successful in gaining control over the company's Merlin@home implantable cardiac devices that wirelessly monitor patient heartbeat and was able to remotely turned off the devices or, alternatively, deliver an extreme shock that would lead to cardiac arrest. The company subsequently updated product software to reduce the risk of remote access.

Companies are also vulnerable to the theft of proprietary technology or methods of production. In 2016, US Steel was attacked by hackers allegedly linked to the Chinese government who stole methods for producing lightweight steel. That same year, Monsanto discovered that an employee had been working with a foreign government to steal information on the company's advanced seed technology. The employee loaded "highly sophisticated and unauthorized software" on his computer that allowed a foreign government to monitor his activity remotely and transmit proprietary data.

More mundane but potentially more lucrative cybercrimes involve the theft of corporate information shared between companies and their advisors. For example, in 2016, prominent law firms Cravath Swaine and Weil Gotshal were among a number of law firms hacked by cybercriminals who stole nonpublic information on corporate clients, which could potentially be used for insider trading. Similarly, the servers of accounting firm Deloitte were hacked and files for a small number of clients were accessed. In 2017, the Securities and Exchange Commission revealed that Edgar, the database that stores the corporate filings of all publicly traded companies listed in the U.S., had been accessed, although the agency did not detail what information was stolen.

Finally, companies and their supply chains have been compromised by ransomware attacks in which cybercriminals disrupt computing systems or demand payment under threat of disrupting systems. Two major attacks occurred in 2017. The first involved a ransomware program called WannaCry which infected computers running Microsoft Windows operating system. The program automatically encrypted computer data and demanded payment in Bitcoin for its release. Over 200,000 computers in 150 countries were affected. FedEx and Nissan reported being materially impacted. A second malware attack in July 2017 took down the computing systems of major multinational corporations—such as Merck, Mondelez, and Maersk—and disrupted business operations over multiple days. Maersk announced that widespread computer outages prevented the company's shipping subsidiary from booking new shipments and providing quotes at selected terminals. Mondelez estimated that the attack reduced second-quarter revenue growth by 3 percentage points.

Corporate Response to Cyberattacks

What actions do corporations take in response to cyberattacks such as these? Many announce steps to improve data security. When customers are affected, they make assurances about their commitment to data protection and offer free credit or identity-theft monitoring. Almost invariably, the company is sued and enters into a settlement (see Exhibit 3).

Exhibit 3: Cost to Settle Class Action Lawsuits for Data Theft

Defendant	Approval	Data Type	Relief to Class	Service Awards, Fees, & Costs
Home Depot	2016	Card data	Up to $13 million for class claims; up to $6.5 million for 18 months of credit monitoring services; security practices changes	$1,000 for each representative plaintiff; $166,925 in costs; $7.536 million in fees
Target	2016	Card data	Up to $20.25 million for class claims; $19.108 million to MasterCard.; reportedly up to $67 million for Visa's claims against Target	$20,000 for 5 representative plaintiffs; $2.109 million in costs; $17.8 million in fees
Sony	2016	Login and personal information	Up to $2 million for preventative losses; up to $2.5 million for claims for identity theft losses; up to two years of credit monitoring services	$3,000 for each named plaintiff; $1,000 for each plaintiff who initially filed an action; $2.588 million in fees
St. Joseph Health System	2016	Health information	$7.5 million in cash payment; up to $ million for class claims; one year of credit monitoring services (offered during remediation); security practice changes	$50,000 in incentive payments for class representatives; $7.45 million in fees and costs
Target	2015	Card data	Up to $10 million for claims; security practices changes	$1,000 for three deposed plaintiffs; $500 for other plaintiffs; $6.75 million in fees
LinkedIn	2015	Login information	Up to $1.25 million for claims; security practices changes	$5,000 for named plaintiff; $26,609 in costs; $312,500 in fees
Adobe	2015	Login and card data	Security practice changes and audit	$5,000 to each individual plaintiff; $1.18 million in fees
Sony Gaming Networks	2015	Card data and personal information	Up to $1 million for identity theft losses; benefit options including free games and themes or month subscription, unused wallet credits; virtual currency; some small cash payments	$2.75 million in fees
AvMed	2014	Personal information	Up to $3 million; security practice changes	$5,000 for each representative plaintiff; $750,000 in fees
Winn-Dixie	2013	Personal information	Up to $225,000 for class claims; up to one year of credit monitoring services; security practice changes	$3,500 for representative plaintiff; $200,000 in fees
CBR Systems	2013	Health information	Up to $500,000 for claims for expenses; up to $2 million for clss claims for identify theft; two years of credit monitoring services; security practices changes	$5,000 for representative plaintiff; $14,064 in costs; $585,936 in fees
Michaels Stores	2013	Card data	Up to $800,000 for class claims; up to two years of credit monitoring services; security practice changes	$2,500 for each representative plaintiff; $35,585 in costs; $1.2 million in fees

Source: Alexander H. Southwell, Eric Vandevelde, Ryan Bergsieker, and Jeana Bisnar Maute, "Gibson Dunn Reviews U.S. Cybersecurity and Data Privacy," The CLS Blue Sky Blog (Columbia Law School), (February 3, 2017). Selected data 2013 to 2016.

Beyond this, however, surprisingly little happens in terms of holding individuals accountable or structural changes that improve cybersecurity expertise at the senior-executive and board levels. For example, among a sample of approximately 50 cybersecurity breaches over the last five years, we find that the CEO is fired or steps down in only a handful of cases. Exceptions include massive data breaches such as those at Target, Equifax, and the website Ashley Madison, in which hackers stole and published the names of 32 million (potentially unfaithful) clients.

Executive pay is almost never reduced. The CEO of Target received no bonus and forfeited $5 million in pension benefits after 40 million credit card accounts were stolen; however, the CEO of the Home Depot suffered no decrease in compensation after more than 50 million credit card accounts were stolen.

Furthermore, executives below the CEO are also rarely fired or penalized. The chief information officer (CIO) of Target was terminated along with that company's CEO. The chief information security officer (CISO) of credit agency Experian was fired after information on 15 million customers was exposed. At Equifax, both the CIO and CISO were terminated along with the CEO. The head of Sony Pictures was fired after the North Korean hack of the company's movie studio; however, Sony's CISO kept his job. We see no evidence of executive terminations—CEO, CFO, CIO, CISO, or other C-suite level executive—following dozens of other high-profile cyberattacks.

Some companies hire forensics firms or cybersecurity experts in the aftermath of data breaches. Cybersecurity firms are brought in to assess how the breach happened and what assets were compromised. Cybersecurity experts are brought in to fill gaps in the firm's internal ranks. For example, JPMorgan hired a former cybersecurity executive from Lockheed Martin a year after the bank discovered that hackers gained access to more than 90 bank servers after stealing the login credentials of a JPMorgan employee. The company also announced plans to increase its data security budget from $250 million to $500 million. Fiat Chrysler took additional steps. After it was discovered that cybercriminals could remotely gain control over its Jeeps, the company developed a program of hiring hackers to identify vulnerabilities in its products and offered to pay between $150 and $1500 for each legitimate security flaw identified.

Few companies add a cybersecurity expert to the board following data breaches. The Home Depot added an IT executive from Lockheed Martin. Neiman Marcus added the chief digital offer from Starbucks after Neiman's payment systems were compromised. Uber recruited the former director of the U.S. Secret Service to serve on an advisory board—not the formal board of directors—a year after hackers stole personal information on 50,000 of its drivers. The hire, however, was part of a broader effort to reduce risk and increase safety for riders, drivers, and the public and not specifically heralded as an increase in security of the company's systems.

We find little less evidence of formal governance changes following cyberattacks. The most commonly observed change is increased disclosure in the proxy. Following hacks, the boards of Coca-Cola, Monsanto, Home Depot, and Staples added specific mention of cybersecurity as a responsibility of the audit committee. Morgan Stanley added language that cybersecurity is a responsibility of its operations and technology committee. Standard Charter added it to its "risk review." Target added data security as a "collective experience" of the board.

We found only one instance of a company making changes to an executive compensation plan to incorporate cybersecurity risk. JPMorgan added cybersecurity as part of the annual performance plans of both its CEO and COO.

Whether governance changes such as these are sufficient to compensate shareholders for the costs incurred in a cyberattack is unclear. Verizon Communications reduced the amount that it offered to pay for Yahoo!'s internet properties by $350 million after Yahoo! disclosed that hackers had stolen the birthdays, email addresses, and passwords of over 1 billion users (later increased to 3 billion users). A spokesperson for Yahoo! described the reduced purchase price as “a fair and favorable outcome.”

To decrease the risk of a cyber threat, some experts recommend the following:

- Elevate cybersecurity within the company’s risk framework. The board should ensure that management and employees take cybersecurity seriously. They should periodically review the company’s potential exposure and cybersecurity policies.
- Develop an action plan to respond to a breach in customer data. The plan should outline employee and board responsibilities, who should be contacted and when, how the company will communicate to the public, and how the breach will be assessed.
- Implement additional safeguards to protect corporate data. Management and the board should review who has access to critical corporate data and trade secrets, and develop policies around how this information is documented, stored, accessed and shared within the company. The board should have its own cybersecurity policies to protect director communications, documents, and conversations.

The complete paper, including footnotes, is available here.

Harvard Law School Forum on
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Ten Questions Every Board Should Ask in Overseeing Cyber Risks

Posted by Yafit Cohn and Karen Hsu Kelley, Simpson Thacher & Bartlett LLP, on Tuesday, June 27, 2017

Editor's note: Yafit Cohn is counsel and Karen Hsu Kelley is a partner at Simpson Thacher & Bartlett LLP. This post is based on a Simpson Thacher-Nasdaq co-publication by Ms. Cohn and Ms. Kelley.

Those who work in the cybersecurity industry believe that there are two types of companies in the United States: "those that have been hacked and those that don't know they've been hacked."[1] Indeed, more and more companies are experiencing data breaches, and it seems that hardly a week goes by without a data breach reported in the headlines.

The consequences of such a breach could be significant. Predictably, a data breach is typically followed by a slew of lawsuits, including putative consumer class action lawsuits and shareholder derivative actions filed against the directors and officers of the company for their alleged breach of fiduciary duties. In recent years, for example, dozens or even hundreds of lawsuits have been filed against certain companies in the retail and healthcare spaces in connection with data breaches. Additionally, various government agencies, on both the federal and state level, have investigated companies for data breaches, and such investigations have resulted in enforcement actions and, consequently, settlements (some of which have been significant). Moreover, data breaches could have a substantial impact on the company's business. The disclosure of a data breach could lead to a meaningful drop in the company's stock price and, as seen in recent months, can reduce the purchase price of a target company significantly. Finally, there is often an incalculable but very real reputational cost to companies that have suffered a data breach. This cost can far surpass the monetary amount paid to settle any lawsuits or regulatory actions.

The costs of a data breach can be exponentially greater where the board is perceived not to have taken the appropriate steps to properly oversee the company's cybersecurity. These added costs include diminished chances to be able to dismiss a shareholder derivative action filed on behalf of the company, as well as negative vote recommendations from proxy advisory firms against the company's directors.

Because of the costs associated with a data breach and the fact that no company today is immune from them, it is essential that each board ensure that it is adequately overseeing the company's cyber risks. Especially for directors who do not have a technology background, this mandate can be a daunting task. The good news, however, is that Delaware sets a very high threshold for finding that directors breached their duty of care; as articulated in the seminal case *In re Caremark*, while directors have a duty to oversee corporate risk, they are only liable if

[1] Nicole Perlroth, "The Year In Hacking, by the Numbers," N.Y. Times, April 22, 2013.

plaintiffs can demonstrate “sustained or systemic failure of the board to exercise oversight—such as an utter failure to assure a reasonable information and reporting system exists.” Recognizing that directors can protect themselves from liability by taking an active oversight role in their company’s cybersecurity preparedness, this post sets out to provide boards with some practical advice regarding how to approach cybersecurity oversight and outlines specific categories of questions directors may wish to consider asking to fulfill their oversight duty.

A Practical Approach: Ten Questions Every Board Should Ask in overseeing Cyber Risks

The overriding principle for any board overseeing cyber risks is that cybersecurity should be approached as an enterprise risk management (“ERM”) issue, rather than a technological problem for the information technology team to handle. The management of cyber risks is just one element of the company’s risk management and oversight, and overseeing such risks should be part of the board’s oversight of the execution and performance of the company’s ERM program (or, if the company doesn’t have an official ERM program, the company’s risk assessment and mitigation activities). Accordingly, while directors may not understand all the technological details surrounding data protection systems and processes, the board nevertheless needs to ensure that it is comfortable that management is effectively managing the company’s cyber risks, as with any other risk the board oversees through the ERM process.

Fundamentally, to fulfill its duty of care in overseeing cyber risk under *Caremark*, the board must allot regular and adequate time on its agenda to discuss cybersecurity matters. At a minimum, the board should meet with the person in charge of organization-wide data privacy and security (such as the Chief Information Security Officer) on an annual basis. Similar to other risks the board oversees, the board should spend this time to ensure that it gains a solid understanding of, among other things:

- The cyber risks the company faces, including the potential impact of those risks on the company’s business.
- The steps management is taking to mitigate those risks.
- How the company is prepared to handle a security breach.

In practice, ensuring that the company is adequately managing its cyber risks can be difficult. To be better prepared—and to ensure that it is properly fulfilling its oversight role—the board should ask thoughtful questions. While there is no “one size fits all” approach to questions a board should ask in its oversight of cybersecurity (particularly as different industries exhibit different risk profiles), we suggest ten categories of questions that boards of all companies should be asking members of management responsible for cybersecurity. In each case, directors should assess the responses to these questions and determine whether follow-up is required. Additionally, depending on the circumstances, additional questions may be necessary.

1. Leadership

Has the company identified a senior person with clear responsibility for organization-wide cybersecurity preparedness, who has support from the top of the organization?

As with any important management function, someone needs to have ultimate responsibility for cybersecurity. This person is often (but need not be) the Chief Information Security Officer.

2. Budget and Staffing

Has management given serious consideration to how much of the budget and how much staff is adequate for proper cyber risk management?

The appropriate budget and staff will depend on a variety of factors, including the industry in which the company operates. Companies in the healthcare and financial services industries, for example, tend to experience more data breaches than companies in other industries, such as construction or real estate. The board's role is to ensure that management is thoughtful regarding its allocation of resources to cyber risk, given the company's industry and circumstances. Additionally, the board should ask questions to ascertain whether management is properly prioritizing the allocation of funds within the overall cyber budget in accordance with relative risk.

3. Comprehensive, Written Cybersecurity Program

Has management formulated a comprehensive, written data privacy and cybersecurity program consisting of reasonable and appropriate policies and procedures?

It is essential that companies formulate a comprehensive, written data privacy and cybersecurity plan that is reviewed by and distributed to all individuals who may be involved in its execution.

a. Prerequisites to Formulating a Comprehensive, Written Cybersecurity Program

In order to create a robust cybersecurity program, management must first

- Know where its data resides and who is accessing it
    - Without this basic information, management will encounter significant hurdles in adequately safeguarding the company's sensitive data.
- Understand the company's top cyber risks.
    - Without knowing what the company's specific cyber risks are at any point in time, management cannot take effective steps toward preventing a breach (or at least mitigating known risks) and cannot allocate its budget appropriately. While many think of data breaches as being synonymous with hacking or cyber-attacks, companies often encounter other types of cyber risk, which could be significant. A prime example is misuse of information by current or departing employees. According to Verizon's 2017 Data Breach Investigations Report. 25% of all data breaches occurred because internal actors abused the access with which they were entrusted—whether maliciously or not (e. g., ignoring protocol or circumventing procedures to facilitate or expedite certain processes). Moreover, even cyber-attacks are multi-faceted and require an understanding of their different phases, each of which generally corresponds to different potential vulnerabilities of the company.
- Know whether there are industry standards applicable to the company's industry and what market practice is among the company's peers in the same industry

- Benchmarking could be an important step in ensuring that the company's cybersecurity program is appropriately robust. In this regard, a company may choose to engage an outside advisor that can provide benchmarking services, comparing the company's data security processes and practices with those of its peers.

The board should ask questions to confirm that management has adequately gathered and addressed aII of this information in formulating its cybersecurity plan. Given that this information can change over time, the board should make sure to revisit these questions at least annually. The board should also inquire whether and how management got comfortable with the fact that its plan is state-of-the-art.

b. Key Elements of a Comprehensive, Written Cybersecurity Program

Naturally, cybersecurity programs will differ, depending on the company and its industry. There are, however, several hallmarks of any comprehensive cybersecurity program. It must

- Ensure that the company does not collect or store non essential customer data.
    - Sensitive information should be retained only as long as the company has a business reason for it. The rationale behind this is simple: If the data is not in the company's system, it cannot be stolen.
    - Indicate how the company ensures that data is destroyed responsibly after it has outlived its business purpose.
    - Ensure that more sensitive data is stored separately with higher safeguards
    - Ensure that employees are granted access to sensitive data only if necessary for them to perform their duties.
    - Indicate the measures the company takes to protect against the downloading of malicious data.
    - Indicate what measures the company takes to reduce the risk that data will be transferred from the company's internal network to the outside internet (e.g., implementing a firewall between the company's internal systems and the internet, blocking particular internet connections known to be used by hackers or creating a list of approved servers to which the company's network is permitted to upload).

The board should ask thoughtful questions regarding each of these and any other significant aspects of the company's cybersecurity program.

c. Reassessing and Testing the Cybersecurity Program

The cybersecurity plan must be reviewed with critical eye at least annually, given that the nature and scope of cyber risks are in a constant state of evolution. The board should ask whether the plan has been reassessed and whether changes should be or have been made to the plan as a result.

Moreover, the cybersecurity plan must be tested to gauge its effectiveness. Some companies conduct such testing in-house, while others hire independent third parties to do so. In addition to inquiring as to whether the company's cybersecurity plan has been tested, the board should ask what the results of that test were and how the vulnerabilities identified during such assessment, if any, have been addressed.

4. Employee Training and Education

Has management instituted effective training programs that instruct employees on the appropriate handling and protection of sensitive data?

As with other forms of employee training, cybersecurity training programs should be meaningful, consisting of more than written policies that employees are required to review and sign. The board should ask probing questions to determine whether management has been adequately conveying to employees the company's protocol, the importance of following it and the consequences of not following it. The board should ensure that it is comfortable that management's training and education programs are properly designed to enable employees to internalize the company's cybersecurity policies. The board should also ask questions designed to ascertain whether management is fostering a culture of compliance with the company's data security policies and protocols and holds accountable those who are not compliant with them.

5. Third-Party Vendors

Has management taken steps to mitigate the cybersecurity risks associated with outsourcing business functions to third parties?

According to the 2016 Soha Systems Survey on Third Party Risk Management, 63% of all data breaches were linked to a third party. This statistic underscores that even if a company has a state-of-the-art cybersecurity program, that program is worthless if the company's vendors, who have access to the company's network and/or sensitive data, do not have similarly robust data security policies and practices. In other words, a company's cybersecurity program is only as strong as the weakest link in its vendor chain.

There are several crucial steps companies should take with regard to their third-party vendors.

- Management should ensure that the company's third party vendors are aware of the company's information securities policies and agree to adhere to them.
- Prior to entrusting a third party with sensitive data, management should review the third-party vendor's data security policies and ask the vendor specific questions about its data security practices to ensure that the vendor properly handles and secures shared sensitive information.
- Management should make sure that any agreement with a third party clearly identifies:
    - how the service provider will safeguard the organization's sensitive data;
    - whether the vendor wiIl subcontract any services to other vendors and, if so, how minimum data security standards wiIl be set; and
    - whether the service provider will notify the company in case of a breach.
- It is critical that companies properly segment the parts of their network accessible to vendors and those that house sensitive data to which the vendors do not need access.

With these points in mind, directors should ask the appropriate members of management thoughtful questions to ensure that the company is doing all it can to safeguard the sensitive information to which its third-party vendors have (or could get) access.

6. Legal Compliance and Regulatory

Does management has an effective system in place for staying abreast of and complying with evolving federal, state and international data security laws and regulations that are applicable to its operations?

Those charged with ensuring the company's data security must be aware of any federal, state and/or international laws that require them to take measures to secure sensitive data. Relevant regulations can change with some frequency, and management must have an effective system in place to track such changes and comply with all regulations. For many companies, this undertaking may entail using an outside vendor. The board should assure itself that management has an effective process for staying updated with regard to applicable legal and regulatory changes.

7. Insurance

Has management given serious consideration to purchasing cyber liability insurance?

In today's environment, management should at least give serious consideration to investing in cyber liability insurance. The board should ensure that management has explored whether it makes sense for the company to purchase cyber liability insurance and should ask questions to understand management's approach to purchasing such insurance. If the company has not purchased cyber liability insurance, the board should make sure that it is comfortable with management's rationale for its decision. If the company has cyber liability insurance, the board should ask about its terms and scope of coverage in an effort to ensure that it is sufficient given the company's specific facts and circumstances.

8. Detection

Has management installed adequate technology not only for preventing the downloading of malicious software but also for detecting and alerting the organization to attempted breaches?

It is essential that every company have robust security software tools and antivirus systems in place to detect attempted breaches. But this alone is not sufficient. Each company must also train security employees on the protocol for responding to automated alerts generated by this technology. If a company has systems that generate alerts but does not have personnel sufficiently trained in handling those alerts, the alerts are not worth much. Accordingly, directors should ask questions to help them understand and assess the measures management has implemented to detect breaches and train employees to respond to breach alerts. Among other things, directors should ask whether any data breaches or incidents have been detected in the past, how long it took for such breaches or incidents to be detected and how their detection was handled by the company's personnel.

9. Comprehensive, Written Breach Response Plan

Does management have a comprehensive, written breach response plan in place?

It is critical that companies be prepared to respond to a breach quickly, effectively and calmly. To that end, companies must have a comprehensive, written breach response plan in place and be clear on what events will trigger that response plan. As part of their response plan, companies should:

- Form a breach response team composed of individuals from key departments (including Information Technology, Legal and Corporate Communications) and identify individual functions and responsibilities in the event of a data breach.
- Select an individual with ultimate responsibility for overall implementation of the plan (i.e., the person authorized to make the final decision on difficult questions).
- Identify outside advisors that may need to be contacted in the event of a breach, such as legal, forensic and public relations specialists, as well as regulators and law enforcement authorities.
- Outline each phase of the response plan, from initial response activities (such as reporting the breach) to strategies for notifying affected parties, to breach response review and the remediation process.
- Create hypothetical scenarios to test the plan (i.e., do a practice run) and address any vulnerabilities identified during those simulations.
- Ensure that the plan is reviewed regularly and revised as necessary.

The board should make inquiries to determine whether management has taken each of these steps to the board's satisfaction and has otherwise formulated a comprehensive breach response plan.

10. Non-Digital Information and Physical Devices

What steps does management take to safeguard sensitive non-digital information?

With all the talk about "cyber," it is important to remember that safe and secure storage of non-digital data, as well as proper destruction of documents and devices, is equally essential. To the extent possible, companies should minimize the locations in which sensitive non-digital information is stored and should ensure the safe and secure storage of this data. Some measures they can take include locking office doors and filings cabinets and/or installing card keys on doors. In addition, companies should ensure that documents (as well as disks, DVDs, flash drives and computers) with sensitive information are properly destroyed before disposal (such as by shredding or burning), as dumpster diving is still a common means of stealing data.

Though it will be focused on overseeing cyber risks in the true sense of the term, the board should also make sure to ascertain whether the company's policies and practices adequately protect sensitive non-digital information in the company's possession.

Conclusion

To fulfill its duty of care with respect to overseeing the company's cyber risks—and to be able to demonstrate, in any future litigation, that it has fulfilled this duty the board must ask thoughtful and strategic questions to understand how management is preventing, detecting and responding to data breaches and incidents and to ensure that it is comfortable that the measures being taken in this regard are sufficient and appropriate.

By asking the questions outlined above—and any other questions relevant to the company's facts and circumstances—and by exercising good judgment, directors can successfully oversee the cyber risks facing the company and the company's plan to mitigate and respond to those risks.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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How Your Board Can Be Ready for Crisis

Posted by Paula Loop, PricewaterhouseCoopers LLP, on Friday, July 7, 2017

Editor's note: Paula Loop is Leader of the Governance Insights Center at PricewaterhouseCoopers LLP. This post is based on a PwC publication by Ms. Loop.

Most companies experience at least one crisis every four or five years. Regularly discussing the crisis plan with management and the results from testing it lets the board understand where there might be gaps in readiness. And it's always better to know about those gaps before a crisis hits. Directors themselves might even need to take a more active role if a crisis spins out of control. Is your board prepared?

We've all seen cases of a company crisis that ballooned out of control and wondered how the company made so many obvious mistakes. Of course, it's easy to be an armchair quarterback, but ensuring management is ready to handle a crisis is an important part of the board's risk oversight. Trying to figure this out while a company is in the midst of a crisis is simply too late.

When something starts to go wrong, it can even be tough to figure out if it's a true crisis. And it may be impossible to predict the full effects—on operations, results or reputation. Even a crisis that's small at the outset can mushroom if it's mishandled.

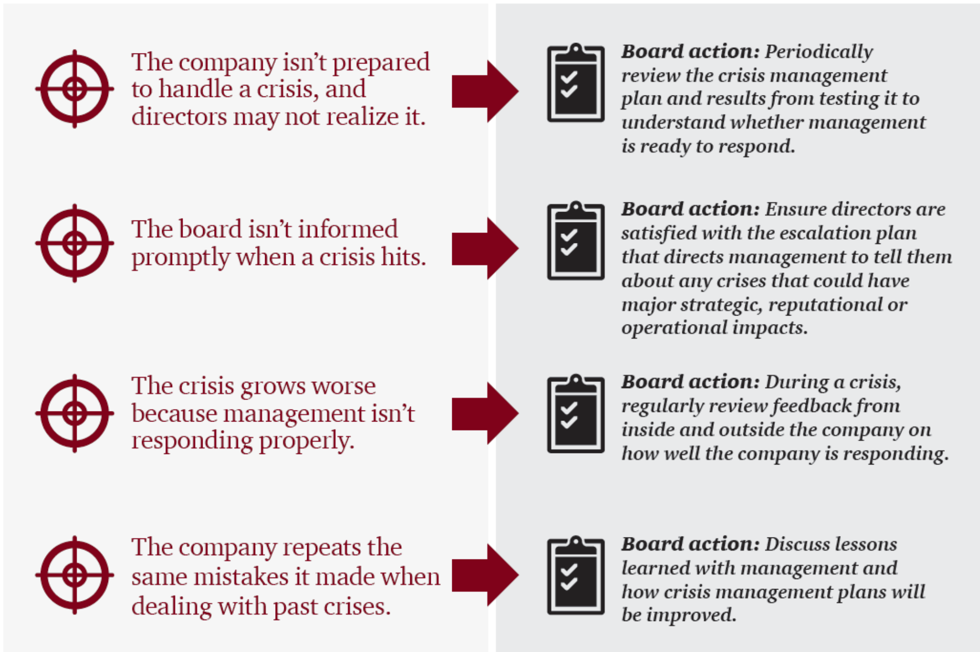
All companies will face a crisis at some point. So it's important for directors to understand whether management has a sound crisis plan in place and to be alert for challenges that commonly arise in crises—before, during and after a crisis occurs.

65% *of CEOs say their companies experienced a crisis in the past three years.*

73% *believe they will face at least one crisis in the next three years.*

Source: PwC, *CEO Pulse Survey*, March 2016.

Addressing the key challenges for directors



Challenge: The company isn't prepared to handle a crisis, and directors may not realize it.

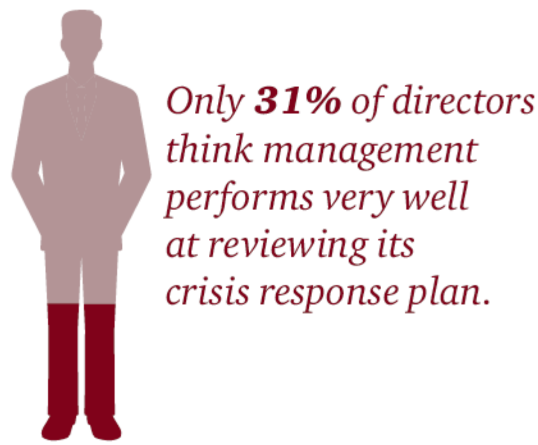
Some boards still aren't asking about crisis management plans. Perhaps they're taking the "fingers crossed" approach of hoping management will be able to handle any crisis that arises. PwC's 2015 Annual Corporate Directors Survey found that 23% had not discussed the subject with management at all and 38% hadn't discussed management's testing of the plan. So it's not surprising that the same survey found that more than a quarter of directors say their board's performance in overseeing crisis management preparedness needs improvement.

And while directors think their boards need to improve, they also clearly think management can do better.

Board action: Periodically review the crisis management plan and results from testing it to understand whether management is ready to respond.

First, ensure the topic of crisis management is on the board's agenda—ideally every year. Understand what a plan should cover to be effective and have management discuss any gaps. Directors will particularly want to focus on who will be involved in responding to a crisis, and whether those people understand their roles and responsibilities. It's also valuable to discuss with management how other companies handled their crises and whether management has considered lessons from what worked and what didn't to improve its own plans.

Directors see room for improvement in crisis management



Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Elements of effective crisis management plans

- Engages a cross functional team for planning and execution
- Identifies crisis management leader(s)
- Delineates roles and responsibilities, including the CEO's and board's roles
- Defines the crisis escalation process
- Outlines expected crisis management activities
- Defines disaster recovery priorities
- Identifies outside advisors to retain as needed
- Provides guidance on crisis communication strategies, including use of social media
- Requires regular testing of the plan

Next, understand how management tests its plans. Using a simulated crisis can test how a company would respond in real time, and whether roles and activities are working together as envisioned in the plan. Also ask whether the company's crisis simulations or tabletop exercises require participants to agree on when and how to inform the board and other stakeholders. Often these exercises identify areas of confusion and uncertainty, and expose gaps in the crisis plan. So, ask about lessons learned—and which areas of the plans management needs to update.

Even the best management team with a solid well-tested plan may not have all the tools or knowledge to handle every crisis. When executives think about the likely types of crises the company might face, they should also identify who can help, including legal, crisis management and communications experts. Knowing who to call ahead of any crisis can save time—and minimize impacts.

Finally, make sure senior executives—including the CEO—are involved in crisis plan testing. They set the tone and have critical roles. If they think a crisis exercise doesn't warrant their attention, others won't either. These are not "one and done" exercises. Periodic testing helps to build and strengthen the company's capability.

***More than a third** of directors would like to see their board spend **additional time and focus** on crisis management plans.*

Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

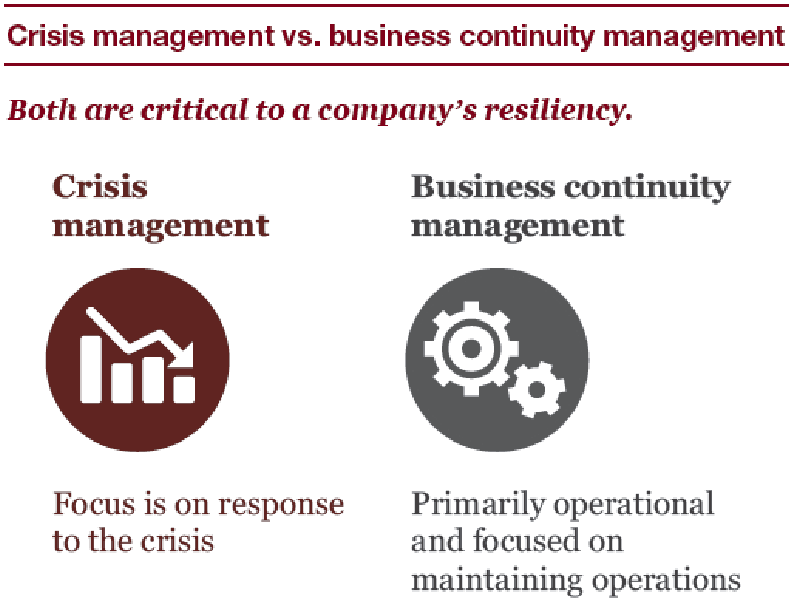
Challenge: The board isn't informed promptly when a crisis hits.

The board hires a CEO it trusts to run the company, including to manage the many challenges and problems a company inevitably runs into. Few everyday incidents require immediate board-level attention.

But from time to time, a major event—from a natural disaster like an earthquake to a man-made one like a data breach—can turn into a crisis for a company. These types of isolated incidents are relatively easy to identify as crises. What's more difficult are the issues that start small—incidents that local business unit management think they can handle and put behind them. It can be difficult to figure out at which point the issue needs to be escalated—and the board informed.

Board action: Ensure directors are satisfied with the escalation plan that directs management to tell them about any crises that could have major strategic, reputational or operational impacts.

First, understand how management defines a "crisis." It's not as easy as it sounds. Whether there's a formal definition or not, the board should discuss when and how it wants to be notified about a looming or ongoing crisis. Much will depend on the nature and scope of the crisis—there is no single answer to when management ought to inform the board. So discuss possible scenarios with management that would require board involvement. And make sure the company's crisis management plan includes a section on board engagement that clearly outlines the escalation expectations and process.



Examples of triggers that would require management to escalate an issue to the board

- Any time people have been hurt
- A plant has been severely damaged
- The crisis will have a significant financial impact
- Critical systems are offline for a specified period of time
- An event occurs that is getting significant negative social media attention

Challenge: The crisis grows worse because management isn't responding properly

When a company is in the middle of a crisis, there are many ways the response may fail.

1. Uncertain crisis scope. Perhaps it's the complex nature of the issue that makes it difficult to understand the scope at the outset. For example, with cyberattacks, it's difficult to know the extent of information compromised or when some of that stolen information may be published or used. Or maybe it's an issue with the company's products—and management is uncertain how widespread the problems are. Or it could be that the crisis occurred in a location that's almost impossible to reach—whether it's deep underwater or in a part of the world where transportation routes or communications channels have been cut.

2. Bungled communications. Well-prepared companies may be able to recover relatively quickly from the event that triggered a crisis—whether that's getting a plant back online or cleaning up an environmental accident. But if the communication about the crisis and the company's response is mishandled, the impact will reach far beyond an operational problem. That's when reputation can really be eroded. In a crisis, the media, the public, customers and employees will be demanding information. But it's tough to provide definitive information about what's happening when even management isn't entirely sure of the cause or the status. Compounding that challenge, false stories may circulate through social media. There might also be differences of opinion internally about when management should communicate and what they should say.

CEOs uneasy about communicating in a crisis

When asked to reflect on their most recent crisis:

55% of CEOs say they felt most vulnerable about communicating adequately with **external** stakeholders.

51% expressed concern when it came to communicating with **internal** stakeholders.

Source: PwC, *CEO Pulse Survey,* March 2016.

In certain high profile cases, politicians or regulators may get involved with inquiries or demands for information. Indeed, congressional committees may call on the CEO to testify before the underlying causes of the crisis are known or fully understood. So CEOs have a tricky balancing act between acknowledging their responsibility and avoiding claims that may arise from sharing information that may be preliminary.

While the company may be focusing on external communications, ignoring internal communications can exacerbate matters. So ensure employees are informed about the crisis itself, that they know where they can get more information if they need it and make sure they know to report all relevant information to a central site.

3. Remembering the rest of the company. It's easy to get overwhelmed in a crisis. It demands a significant amount of time and energy from the CEO and senior leadership. But losing sight of the ongoing business can make the impact of the crisis worse. Competitors will be watching for ways to profit from a company's woes. And other more nefarious actors—cybercriminals—may also try to exploit various vulnerabilities, relying on the fact that management is distracted.

Board action: During a crisis, regularly review feedback from inside and outside the company on how well the company is responding.

The CEO is typically the face of the company in a crisis. Companies also depend on their communications executives and often public relations and law firms to help navigate messaging. Law firms can advise on required communications, such as those to regulators, and also offer perspectives on how to ensure that any disclosures the company makes voluntarily don't expose it to increased liability. Crisis communications experts can guide senior management on a communications strategy, including how frequently to report despite the absence of additional information. People still want updates, even if the answer is, “we don’t know.”

For its part, the board will want to understand the planned approach to communications. Directors should expect to see clear messaging on what has happened, who is accountable, how the company is responding and what will be done to address problems in the wake of the crisis. And they should push back if the communications don’t appear to align with the company’s core values.

While the communications team is developing messages and updates, they—and the board—need to stay on top of how the public and other stakeholders are responding. It’s easy to be caught in an echo chamber without a clear perspective on how the information is being received and processed outside the company.

That means boards should look beyond management for perspectives about the crisis. Directors can follow news and social media channels to stay current, as well as get “sentiment analysis” from outside experts. Directors can also hold executive sessions with these experts just to be sure they’re getting the full picture. The board will need to challenge management and demand course correction if it senses that the messages aren’t working.

While the CEO is typically the main spokesperson, that can present a problem if the CEO’s credibility is badly damaged—particularly if he or she is at the center of the crisis. Such cases often require someone else to step into the spokesperson role. That may be an interim company leader or even the board chair or lead director.

The board should expect to be updated regularly on how the crisis is being handled. During the height of the crisis the briefings could occur daily or more often. That may prompt the board to consider appointing a special committee to help with oversight.

Then there is the rest of the business to consider. Ask which executives are designated to manage the ongoing operations. And make sure they’re getting the resources and support they need. Also challenge whether they understand the full scope of the crisis’ impact on operations. For example, when an earthquake and tsunami hit Japan in 2011, it took some companies an extended period to register how the damage to their suppliers would impact their supply chains.

What role does social media play in a crisis?

Social media has given everyone a public platform, which makes it especially important that someone monitor it during a crisis. Many people turn to Facebook and Twitter first for news when a crisis erupts.

How can companies manage social media chatter, especially in the wake of a crisis? First, policies and procedures do matter, so people need to be trained about what they can and cannot say on social media when representing the company. And it’s important the corporate communications function finds opportunities to use social media productively—to get out messages to the public, customers, employees and their families, and other stakeholders, or to provide updates on how the company is responding to the crisis.

Challenge: The company repeats the same mistakes it made when dealing with past crises.

Once a crisis has passed, people tend to take a breath as they recover and get back to “business as usual.” But unless there’s a thoughtful post-mortem, and adjustments, if needed, to the crisis plan, the company risks repeating any mistakes it made in future crises.

Board action: Discuss lessons learned with management and how crisis management plans will be improved.

Directors will likely want to understand the root causes of the crisis the company has just weathered. This allows the board to weigh in and discuss whether appropriate follow-up actions have been taken.

Management will often lead such investigations. But if management itself seems to be at the heart of the crisis or if the event was significant enough, it may make sense for the board to decide whether an independent investigation is needed. (A natural disaster probably won’t need an independent investigation, for example, unless the crisis management plans were woefully inadequate.) As well as looking at root causes, management should assess what improvements are needed to the company’s crisis plan. Did we have the right people and experts involved? Did our employees know what they needed to do? How strong were our regulatory relationships? Did our communications strategy work? Did we have the information and intelligence we needed to respond? Directors will want to understand what was learned and how crisis plans are changing as a result.

In conclusion...

Knowing the company has a sound crisis plan can give directors greater confidence that management is ready to respond to a future crisis. Since many directors have had to deal with crises in their executive roles, they can use their experience to advise management. The better the plan is, the more likely it will help a company handle a crisis quickly and effectively.

It doesn’t all have to be bad news. Companies that successfully respond to a crisis can ultimately emerge stronger and be viewed more positively by their customers, employees and other stakeholders.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Federal Reserve Takes Severe and Unprecedented Action Against Wells Fargo: Implications for Directors of All Public Companies

Posted by Edward D. Herlihy, Richard K. Kim, and Sabastian V. Niles, Wachtell, Lipton, Rosen & Katz, on Monday, February 5, 2018

Editor's note: Edward D. Herlihy, Richard K. Kim, and Sabastian V. Niles are partners at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell publication by Mr. Herlihy, Mr. Kim, and Mr. Niles.

In a stinging rebuke, the Federal Reserve on February 2nd issued an enforcement action barring Wells Fargo from increasing its total assets and mandating substantial corporate governance and risk management actions. The Federal Reserve noted in its press release that Wells will replace three current board members by April and a fourth board member by the end of the year. In addition, the Federal Reserve released three supervisory letters publicly censuring Wells' board of directors, former Chairman and CEO John Stumpf and a past lead independent director. These actions are a sharp departure from precedent, both in their severity and their public nature. They come on the heels of significant actions already taken by Wells, including appointing a former Federal Reserve governor as independent Chair and replacing a number of independent directors as well as its General Counsel.

As a matter of regulatory policy, we believe that these actions are more piercing political statement than a change in direction from the deregulatory posture of the Trump Administration or the recent Federal Reserve pronouncements about reducing the regulatory demands on bank boards of directors. It is telling that the Federal Reserve took action on Chair Janet Yellen's last day in office and that its press release features a quote from her—she rarely commented on enforcement actions during her tenure. That being said, there are important aspects of these actions that will reverberate within and beyond the financial sector, underscoring the ever-evolving challenges facing corporate boards:

- the characterization of compliance breakdowns as failures of governance and board oversight;
- the required replacement of board members;
- the censuring of directors after they had left the board for "lack of inquiry and lack of demand for additional information";
- the expressed view that a board's composition, governance structure and practices should support the company's business strategy and be aligned with risk tolerances;
- the expectation that business growth strategies be supported by a system for managing all key risks, including those arising from performance pressure and compensation

incentive systems and the potential that business goals could motivate compliance violations and improper practices;

- the view that “management assurances” of enhanced monitoring and handling of known misconduct be backed up by “detailed and concrete plans” reported to the board; and
- the citation to the company’s published corporate governance guidelines detailing duties and responsibilities that were not fulfilled.

In its enforcement action, the Federal Reserve required that Wells submit written plans to enhance its board’s effectiveness in carrying out its oversight and governance functions and to improve its firm-wide compliance and risk management program. Once the Federal Reserve has approved these plans and Wells has implemented them, Wells must arrange for an independent review of the improvements that have been made, which must be completed by September 30th. Wells must then arrange for a second independent review to assess the efficacy and sustainability of the improvements. Until the initial independent review is completed to the Federal Reserve’s satisfaction, Wells is barred from increasing its total consolidated assets from the level reported to the Federal Reserve as of December 31, 2017.

While the bank regulators have in the past issued enforcement actions limiting banks from increasing their total assets, these actions have been reserved for deeply troubled institutions with severe capital and credit issues and not for financially strong institutions such as Wells. The Federal Reserve likely took this unusual step because Wells was already barred from making acquisitions as a result of other legal and regulatory restrictions. Nevertheless, Wells Fargo acquired a large portion of the assets of GE Capital in 2016 structured in a manner to avoid its regulatory bar on acquisitions, and this may have been a further impetus for the Federal Reserve’s action.

Perhaps more surprising was the Federal Reserve’s public release of supervisory letters to each of Wells Fargo’s board members, former Chairman and CEO and past lead independent director criticizing their performance. Normally, supervisory letters are kept confidential by the regulators. In the letters, the Federal Reserve pointed to an overall lack of effective oversight and control of compliance and operational risks. These letters express the view that directors need “to have sufficient information from firm management to understand and assess problems at the firm” and that this requires “robust inquiry and demand for further information.” Especially with respect to board leaders, once problems become known, failure to “initiate any serious investigation or inquiry” or to “lead the independent directors in pressing firm management for more information and action” will expose directors to criticism and potential reputational damage.

Last August, the Federal Reserve issued a proposed corporate governance proposal narrowing its focus on supervisory expectations for bank boards of directors, noting in its release that “boards often devote a significant amount of time satisfying supervisory expectations that do not directly relate to the board’s core responsibilities.” Proposed Guidance on Supervisory Expectations for Board of Directors, 82 Federal Register, 37219 (August 9, 2017). In our view, these letters do not contradict that guidance—rather they lay out more specific supervisory expectations for boards when they become aware of specific instances of misconduct. The public release of these letters to Wells Fargo’s current and former board members should be viewed as putting other companies on notice regarding the expectations laid out within them.

We note that there remains the possibility of further enforcement actions by the Federal Reserve involving Wells. In the current enforcement action, Wells agreed to fully cooperate and "to use its best efforts, as determined by the Board of Governors," to facilitate investigations by the Federal Reserve "of whether separate enforcement actions should be taken against individuals" who are or were affiliated with Wells. Given the highly public nature of the Federal Reserve's actions, the Congressional hearings that will likely follow, and the continuing outcries for holding individuals accountable in cases of corporate misconduct, it may be politically difficult for the Federal Reserve to refrain from taking further action against individuals previously or currently associated with Wells.

While financial institutions operate within their own unique regulatory framework, all companies should reflect on the increased expectations on board leaders and the board as a whole with respect to assuring that appropriate risk management and escalation systems are in place. This includes setting high expectations for General Counsels and compliance departments and following up assertively with robust and prompt inquiry and tracking when evidence emerges of serious compliance breakdowns. Because high-quality, timely and credible information provides the foundation for effective responses and decision-making by the board, the ability of a board and board committees to perform their oversight roles is dependent upon the relationship and flow of information among the directors, senior management, legal and compliance departments and the risk managers in the company. If directors do not believe they are receiving sufficient information, they should be proactive in asking for more, and directors should work with senior management to ensure that their information needs are being met, including agreeing on the type, format and frequency of risk, business and other information required by the board.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Reforming Culture and Conduct in the Financial Services Industry: How Can Lawyers Help?

Posted by Michael Held, Federal Reserve Bank of New York, on Thursday, March 23, 2017

Editor's note: Michael Held is general counsel and executive vice president of the Legal Group at the Federal Reserve Bank of New York. This post is based on Mr. Held's recent remarks at Yale Law School's Chirelstein Colloquium. The views expressed in this post are those of Mr. Held and do not necessarily reflect those of the Federal Open Market Committee or the Federal Reserve System.

My topic today is culture in financial services. Reform of culture has been a priority for the Federal Reserve Bank of New York for several years. Many of the observations I will share today are based on that work. But, as always, what I have to say reflects my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.[1]

My thesis is that lawyers should play important roles at financial firms as advisors not just on law—what is legal or illegal—but also on culture. As I see it, culture is distinct from both public law and private rules. That doesn't mean that culture is completely independent of either. Indeed, a group's culture often informs and is informed by its rules. But culture is a powerful force in its own right.

I do not mean to imply that a lawyer should rush headlong into areas best reserved for organizational psychologists. A lawyer's advice on culture should always be grounded in law, and lawyers should be cautious in venturing too far afield from their core expertise and fundamental role as advisors on the law.

That said, an in-house lawyer is well-suited to assess and help improve an organization's culture. A lawyer can supply a degree of both independence and insight that is required to understand an organization's culture without becoming captive to that culture. Independence comes, in part, from a lawyer's training, independent code of ethics, and reporting responsibilities that ultimately go up to the board of directors. Insight comes from building a trusted relationship with a client over time.

A lawyer's aim should be what Gillian Tett from the *Financial Times* has described as the viewpoint of the "insider-outsider," someone with both understanding and objectivity.[2] Ben Heineman, a recent speaker at this Colloquium and a former general counsel of General Electric, has another take on the same objective: A lawyer is both a partner and a guardian. There is some inherent tension between an insider's and an outsider's perspective, between being a partner and

[1] Celine Hwang and Thomas Noone assisted in preparing these remarks. I am also grateful to Anne Thoma for her contributions through the New York Fed's summer intern program.
[2] Gillian Tett, *The Silo Effect* 50 (2015).

a guardian. But, as Heineman argues, "these potentially paradoxical ideas can co-exist and, indeed, can be complementary."[3]

Some might argue that this is an expansive view of a lawyer's role. I believe it is the appropriate view. A lawyer who is both a partner and a guardian—an insider and an outsider—can greatly benefit a financial services firm. You might apply the same thinking to any number of contexts and clients. But since my experience is largely with banks, I'll stick with what I know.[4]

Let me first explain what I mean by culture. I'll then address the relationship between culture and law, and how lawyers can contribute to a culture that respects law. Finally, I'll propose an idea for a new law to address a cultural problem, and ask for your input on how the idea might be refined. I promised Nancy I would wrap up with plenty of time for questions.

For the purposes of our discussion today, I will use the word "culture" to mean the shared norms within an organization that are evidenced through behavior. A strong culture is highly effective at transmitting norms within a group and helping newcomers assimilate to those norms. We each observe our environments. Often—sometimes too often—we conform our conduct to what we see around us. As one of the New York Fed's summer interns put it, "Culture is best understood as something that makes people feel safe and confident in their inherited understanding of the world."

This insight suggests why culture can sometimes cause trouble. An organization's culture may yield too high a degree of adherence—or a dangerous lack of questioning. Culture can sometimes lead to a conclusion that an action is right because it appears to be accepted or ordinary. After all, if conduct is accepted, it must be safe and alright—right?

This assumption, and others like it, are frequently at the core of enforcement investigations by the Federal Reserve. If you were to ask "Why do people commit financial crimes," it might be tempting to respond, simply, "They're greedy." Some people are greedy. And some of those people commit financial crimes. In my opinion, however, the reasons why bankers break the law are varied and complex. And, in many instances, misconduct is related to an organization's culture.

Let's face it: In figuring out how to behave on an everyday basis, people may not always refer to laws or rules or regulations or policies. They may not always consult their in-house counsel or their compliance department. I know that probably sounds terrible for me to say, particularly as a lawyer. Make no mistake, I place the highest value on our laws and regulations. When I first joined the Fed, a colleague passed along a saying that he learned while in law school: Laws are the wise restraints that keep us free. I firmly believe that. Looking at the role of culture is *not* the same thing as excusing personal responsibility. There is no "culture excuse" when people break the law. I want to be clear on this. Laws and regulations matter. As a supervisor, adherence to laws and regulations is my top priority.

But I'm also a realist.

[3] Ben Heineman, *The Inside Counsel Revolution* 7 (2016) (discussed on the Forum here).
[4] I use the terms "banks" and "bankers" informally, to mean any supervised financial institution or its employees.

I think of a new, junior banker—fresh out of school, or otherwise new to an organization. In my experience, junior bankers typically don't consult "the law" for guidance on a day-to-day basis. They take their cues from their peers and immediate supervisors. That's how they discover what is important—to gauge the difference between what is right and what is wrong, or between what is successful and unsuccessful. A newly-minted trader, for example, may not realize what's wrong with a particular activity, especially if the conduct has the appearance of an accepted, ordinary, or highly rewarded industry practice. More often than not, it's an organization's culture—the shared norms conveyed through conduct—that provides instruction.

Another noteworthy aspect of cultures at some banks—again, observed in hindsight through enforcement investigations—is that they do *not* tolerate failure. A banker with a track record of success (academically, athletically, or professionally) may feel pressure to misstate performance indicators to preserve a self-image of success or to keep a job. The employment structures within many a firm—for example, the tournament-style systems of job retention—may contribute to this. In any year, a bank may part ways with anyone in the bottom ten or twenty percent of a peer group, based on financial performance. These bankers operate in an environment that does not tolerate failure—even when failure is guaranteed by design for a large percentage of the workers. That's dangerous for several reasons: It can encourage cutting corners. And it discourages escalation of problems.[5]

In other cases, a misguided desire to help teammates may have contributed to misconduct. This is also a feature of culture. Teamwork and employee loyalty are, no doubt, worthy principles. But in the LIBOR and foreign exchange scandals, for example, loyalty to friends and teammates became a reason for manipulating market benchmarks. This behavior may indicate a culture in which the company or a team is somehow viewed as above the law, or at least apart from it, as long as you are a high performer. That's a dangerous mindset for a bank, which exists in part to provide the intermediation activities on which other participants in the economy depend.[6]

The rate-rigging scandals involving LIBOR and foreign exchange markets are further instructive about culture in two respects. *First*, cultures may exist within an industry in ways that are not firm-specific. In some instances, the allegiances of the traders involved in the LIBOR and FX scandals ran toward one another, almost as a guild of traders, rather than to their employers or customers. Loyalty to the guild may have provided a sense of security and belonging. *Second*, any organization may have multiple cultures or subcultures. Indeed, most people who worked at banks involved in benchmark manipulation did *not* participate in misconduct.

It can be tempting to define away problems like LIBOR and foreign exchange manipulation as isolated to a "rogue unit." Anytime someone uses the term "rogue," as in "rogue trading unit" or even "rogue trader," the hairs on the back of my neck stand up. Yes, it is sometimes the case that one or more people simply "go rogue." But it may be more likely that a firm has a more systemic problem on its hands. Branding a behavior as "rogue" does not explain why it occurred. Even if the scope of misconduct appears limited to a few people, an underlying reason—such misaligned incentives or loyalties—may apply more broadly within an organization, and may lead to problems

[5] *Cf*. Wieke Scholten and Naomi Ellemers, "Bad apples or corrupting barrels? Preventing traders' misconduct," 24 Journal of Financial Regulation and Compliance 366, 336-67 (2016) (describing the case of Kweku Adoboli, who booked non-existent hedges to cover accumulated risk in his trading book).

[6] *See* Dan Awrey, William Blair, and David Kershaw, "Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?" 38 *Del. J. Corp. L*. 191, 217 (2013) (arguing for "a norm of 'other regarding' behavior within financial services firms, one which … attempts to induce firms to take into account the private and social costs of their decisions").

elsewhere. Without an understanding of root causes, how can you know that a particular behavior is random, or that its breadth will remain limited? Or, to borrow a common metaphor—and we lawyers love to use metaphors—how can you know that you are dealing with a single bad apple or a bad barrel?

Let me make one final observation about culture. At the risk of stating the obvious, every organization has a culture. It may be embraced or eschewed, nurtured or ignored. I think an organization that ignores culture does so at its own peril. Or, more optimistically, culture can be a powerful tool for achieving the firm's goals.

What, then, does law have to do with culture? And what role can lawyers play?

As I mentioned, having a law on the books does not mean people will follow it. And being a lawyer does not always mean clients will listen to you. Some believe the solution is more laws. (Only the enlightened few argue for more lawyers.) But as New York Fed President Bill Dudley has argued, rules are "necessary, but not sufficient."[7] It is impossible to create a rule for every situation. Gaps in a regulatory regime are inevitable. Groups will develop shared norms for filling those gaps. So, for that reason alone, we need to look to culture as well as laws for solutions.

In addition, the pace of rulemaking is not always commensurate with the pace of rule breaking. Focusing exclusively on rulemaking creates a risk of fighting last year's scandal.

What's more, laws are good at setting the outer limit of acceptable behavior—what is clearly prohibited. They are less frequently and less reliably used to define what is optimal or what is good.

Finally, a regime dependent on bright-line rules may, strangely, entice people to walk right up to the edge of a rule—or to find creative ways around the rules. A proliferation of technical rules prompts us to ask what we *can* do, not what we *should* do.

In short, law *can* shape culture and conduct—but not always as intended. I worry that lawyers in financial firms are too often asked by clients, in effect, "How close to the legal line can I get?" Or maybe they're instructed, "Just tell me if this is legal or illegal, not what I should do." Worse, I worry that lawyers, intentionally or not, enable this kind of thinking. Lawyers are certainly not immune from cultural influences.

And recall my observation earlier about culture: Repeated behavior becomes a shared norm. Preet Bharara, the United States Attorney for the Southern District of New York, has a few views about this. He has described two particularly pernicious forms of culture, based on cases handled by his office: the culture of *minimalism* and the culture of *formalism*. In a minimalist culture, an organization does the "least amount possible to be in some kind of compliance with rules."[8] In a formalist culture, technical requirements take precedence over principles. Either way, it's only a matter of time before these cultures lead people to cross the line. When this happens, CEOs

[7] William C. Dudley, Remarks at the Culture Imperative: An Interbank Symposium (Jan. 11, 2017).

[8] Preet Bharara, "Criminal Accountability and Culture," Remarks at the Federal Reserve Bank of New York's Conference: Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue (Oct. 20, 2016).

have to explain themselves to people like Preet Bharara—and, if you're a banker, to me and my colleagues.

In my view, lawyers must push against minimalism and formalism. They must argue not just for what is legal, but for what is sound and right. Lawyers should play a role as a part of the conscience of the organization.

Now, this is not a new concept. I certainly didn't invent it. And you've heard recently from a leading expert in the field—Ben Heineman. I state it here because it is so important to what we as lawyers do.

Good in-house counsel will combine traits of outsiders and insiders that can produce keen insights and contribute to successful results. As *outsiders*, lawyers are trained to spot issues and, in the common law tradition, to reason by analogy and common sense. We also learn *some* actual law—not necessarily a whole lot, but enough to be able to learn more as we go.

I also think that lawyers are natural questioners—a self-selecting bunch. Questioners tend *not* to be yes-men or yes-women, afraid of rocking the boat. One of my predecessors at New York Fed put it this way, writing to the Legal Department in 1964: Lawyers should be "neither obstreperous nor mousy."[9]

We also enjoy professional standards that help resolve difficult ethical questions. Indeed, the rules that govern our profession expressly permit advice on non-legal matters.[10]

Lawyers can also, and should, function as trusted *insiders* and advisors. We're partners in addition to guardians. In-house counsel, in particular, are able to build longstanding relationships with their clients. We get to know their businesses. We have opportunities to build trust and confidence, which can make us that much more effective and credible when we raise questions.

Retained by the organization, we are invited to take an enterprise-wide view, not a narrow view of a particular business line.[11] At large financial firms, lawyers advise most divisions, if not all of them. Lawyers can leverage their broad insights across a financial services firm. They can discuss among themselves how the conduct they observe in one division compares with the conduct observed by colleagues in another division.

In this way, lawyers can identify and help combat troublesome silos of behavior—to help firm management identify whether they have an issue in an isolated "rogue" unit, or a more systemic problem. For a junior lawyer, this might mean escalating up when she spots issues. For a more senior lawyer, this might mean engaging with peers in management—including the chief risk officer or chief compliance officer—to help ensure that issues are identified and addressed.

[9] John Clarke, "The Role of the Legal Department," 6 (June 10, 1964). I am grateful to Ernie Patrikis, another of my predecessors as General Counsel, for retaining and recirculating this memo.

[10] *See* Restatement (Third) of the Law Governing Lawyers § 94(3); Model Rules of Professional Conduct of the American Bar Association § 2.1.

[11] *Cf*. Association of the Bar of the City of New York, "Report of the Task Force on the Lawyer's Role in Corporate Governance" 3 (Nov. 2006) ("Lawyers are often in a position to influence or facilitate the conduct of their corporate clients.").

All this is to say, lawyers should support their clients with a healthy skepticism. When a CEO chuckles over the ethical lapses at another firm, assuming that such a thing could never happen at her firm, that is precisely the moment to step in, and challenge, and ask how the CEO gains this comfort. Are her assumptions are well-founded? Supervisors at the Federal Reserve call this "effective challenge."[12] Lawyers can look out for effective challenge at all levels of an organization. They themselves should also be effective challengers.

In addition to challenging a CEO's schadenfreude when another firm experiences trouble, here are some categories of questions that, while not strictly legal, a good lawyer should ask. Each of these categories requires both the understanding of an insider and the independence of an outsider.

The first category is *structure*. Does a particular way of organizing a business run the risk of unacceptable conflicts of interest? Are roles within a group clearly defined? Are they over-defined, so that employees lose sight of the big picture? Are control functions participating in key decisions? Are lawyers themselves siloed within separate business units? Are they consulted early, or only at the last minute? To quote again from one of my predecessors at the New York Fed: "Please let us get in on the take-off, if you expect us to be in on the crash landing."[13]

The second category is *communication*. Are principles and tasks made clear? Are problems escalated early or belatedly? How is bad news relayed and received—both from employees to managers, and vice versa? Note that, in both directions, communications pass through a middle layer. So, you might also ask how intermediaries influence the content of communications. In addition, do control areas communicate and coordinate with each other? Do lawyers share with each other and with other control areas such as compliance and risk officers about what they are seeing?

The third category is *leadership*—in particular, what has been called "character at the top."[14] Do the messages from senior leaders match their actions? Do senior leaders set an example of encouraging questions? Do they seek out feedback and input? Do senior leaders ask questions themselves and demonstrate openness to alternative ideas? How do they handle the inevitable mistakes that will occur in large organizations? Do they learn from them?

A fourth category, which I think is particularly important, is how the firm treats employees who *escalate issues*. This is where I am focusing many of my efforts as general counsel at the New York Fed. For an institution with so many public responsibilities—and, indeed, for any institution that wants to be effective over the long run—it is mission-critical that employees feel comfortable escalating potential problems and challenging accepted points of view. Do we seek out a diversity of viewpoints? If not, how do we know it the best idea wins? This is not always easy or natural. I think human beings have a natural bias to seek out others who have similar

[12] *See*, *e.g.*, Supervision and Regulation Letter 15-18, "Federal Reserve Guidance on Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms," 10 n.12 (Dec. 8, 2015) ("The term 'effective challenge' means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results."); Supervision and Regulation Letter 11-7, "Supervisory Guidance on Model Risk Management," 4 (Apr. 4, 2011) ("Effective challenge depends on a combination of incentives, competence, and influence… . Such influence comes from a combination of explicit authority, stature within the organization, and commitment and support from higher levels of management.").

[13] Clarke, *supra* n.9, at 23.

[14] Thomas C. Baxter, Jr., "The Rewards of an Ethical Culture," Remarks at the Bank of England, (Jan. 20, 2015).

views to our own. But this only results in group-think. So, I encourage you to pay close attention to how your organization encourages escalation and responds to dissenting or divergent views.

None of these questions are strictly, or even largely, legal. But, paying attention to these issues is good legal risk management—part of being both a partner and a guardian. In my view, organizations with good structures, communication, and leadership—and, perhaps above all, organizations that welcome divergent views and promote raising one's hand—will, in my opinion, have fewer legal problems."

Of course, lawyers have to be mindful of the possible consequences, however unintended, that the partner/guardian or insider/outsider model may create. Lawyers may be perceived as giving authoritative advice on issues for which they should be only one of many voices. While lawyers may have a monopoly on rendering legal advice, they do not have a monopoly on advising as to what is "right." "We are not priests or rabbis."[15] And as lawyers become more vocal on ethical issues, there is a risk that tough ethical questions may be routinely outsourced to the lawyers. I get nervous when I hear a client say, "I'm just doing this because the lawyers told me to." This would be the opposite of the result that I would like to see: that business lines feel more responsible and are held more accountable for their own ethics and conduct. Finally, the more lawyers engage on non-legal questions, the more doubtful the privileged nature of communications with them becomes—and, an uncertain privilege, is not much of a privilege at all.

I believe these risks are manageable. They require careful attention, but not anything extraordinary. On the question of privilege, for example, client confidences should be protected from discovery if lawyers ground their advice in legal matters. And, by the way, this is an important check against straying too far from our expertise. Our advice is more valuable and more credible when we speak from our training, knowledge, and experience.

Moreover, in my view, the benefits far outweigh any possible risks. Paying attention to structure, communication, leadership, and escalation in a firm provides opportunities to spot potential misconduct early and intervene before problems grow even larger. Lawyers can also serve as models in this regard, prompting non-lawyer colleagues to respond in kind. Remember, culture is contagious.

Beyond spotting issues, lawyers must be proactive in solving problems, even ones that are of their own making. I will give you an example that we are struggling with today. To extend the metaphor I introduced earlier, we often call this the "rolling bad apple problem."

When an employee moves from one bank to another, it is standard practice for an employer to provide the equivalent of name, rank, and serial number. You can blame lawyers for this. I mentioned earlier that lawyers are natural questioners. I think we're also genetically averse to risk. Providing information about employees creates a risk. For example, if the information provided is incorrect, there is a risk of a lawsuit for defamation or tortious interference—to name just two possible causes of action. And, regardless of the merit of a claim, it is very difficult to get employment cases dismissed at the pleadings stage. Most suits go to discovery, which is expensive. So, lawyers advise clients that the best option is to say as little as possible.

[15] Id.

Here's the problem with that legal advice. It's been observed since the financial crisis that some of the persons most directly responsible for misconduct were not first-time offenders. They had records of misconduct at previous employers. But their former employers did not share information about misconduct with their prospective employers. Thus, a banker with a record of misconduct could move from firm to firm, spreading bad practices. Remember what I said earlier: Culture is contagious. Bad behavior can travel with a banker across firms, but his official record does not travel with him. What's legally advisable for one organization results in a collective action problem for all firms.

New York Fed President Bill Dudley spotted this problem a few years ago and proposed a database of banker misconduct to address the issue.[16] In theory, a change in the law could establish two duties for financial institutions: a duty to report misconduct and a duty to check the database before an employee begins work.

The duty to report should arise when a covered employee leaves a firm in connection with some misconduct, defined to include not only violations of law, but also bank policies that govern behavior. Banks must explain the circumstances of misconduct in reasonable detail, such that a prospective employer could understand what happened. Those records would be available to other financial institutions for some reasonable period of time—say, five years—and would then expire.

The duty to check the database should arise after a conditional offer is made, but before the individual begins work. An offer of employment would be contingent upon a database inquiry. The prospective employer could withdraw its offer if it were not satisfied with what it sees in the database.

To overcome the legal risk that inhibits disclosure, a federal statute could provide limited civil immunity for reporting—a safe harbor. Banks would not face suits for money damages by former employees. But their *reports* to the database *would* face judicial scrutiny. To guard against abuse by banks, the statute should entitle employees to prompt notice and two options to pursue redress in the event that they believe a report about them is false: a low-cost, fast-track ombudsman hearing, or a full judicial review in federal court. This is critical. Remember that most people who work in financial services firms are not millionaires. The official sector would also remain free to take action—criminal or civil—to combat abuse of the database and its safe harbor.

There are costs and benefits to this idea—again, I'm only dealing with a hypothetical law, not any statute on the books or pending before Congress. And the database idea is not a cure-all. It will not deter all bad conduct and will not, standing alone, restore the trustworthiness of banks. But, on balance, I think a database will *help* overcome a collective action problem in the financial services industry, which will benefit both banks and their customers.

The database idea would benefit from input by prosecutors and regulators, employment lawyers for plaintiffs and defendants, in-house counsel, and others with empirical insight on human

[16] William C. Dudley, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry (Oct. 20, 2014).

behavior. It is, in short, a prime opportunity for collaboration and refinement through forums like this one. I welcome your comments and questions.

One final note before I open the floor for questions. Some of you may be saying to yourselves, "Well, that was a riveting and insightful speech. [You're welcome.] But since I'm never going to work in financial services, I don't really need to worry about any of this stuff."

There is an ongoing debate as to whether there is something intrinsic and idiosyncratic about financial services that creates especially egregious culture problems. I've tried to stay away from that discussion today. Instead, I've tried to frame my remarks about culture in a way that can be extended beyond financial services to a variety of industries—and, dare I say it, even to academic settings or public sector institutions like the New York Fed. I would respectfully suggest, though, that you should be concerned with culture in financial services even if you're planning a career in a very different field. That's because problems in financial services don't tend to stay in financial services. They involve clients of those firms, and often have consequences for other sectors of the economy.

What's more, cultural problems are everywhere. Think of the problems at GM with its faulty ignition keys, or problems in the pharma industry with inappropriate sales practices, or just recently the headlines about a ride sharing company that allegedly used software to evade local laws. In each of these instances, and in many others, I always wonder how the lawyers could let this happen. I'm not the only one. "Where were the lawyers?" is a question often attributed to Judge Stanley Sporkin following the collapse of Lincoln Savings and Loan.[17] A decade later, the post-mortem evaluation of Enron criticized lawyers who "saw their role in very narrow terms, as an implementer, not a counselor."[18] And, within the last year, Ben Heineman posed the question again regarding Wells Fargo.[19]

Culture is an issue that you, as lawyers—both starting out in your careers and as you become more seasoned—will need to work with, regardless of where you end up or who your client is. Hopefully, you will be positioned to help your clients think about these issues proactively to mitigate risk *ex ante*, rather than just reactively, after a firm experiences significant, even existential, problems.

[17] *Lincoln Savings & Loan Ass'n v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990) (Sporkin, J.) ("Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated? … Where also were the outside accountants and attorneys when these transactions were effectuated? … What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.")

[18] Final Report of Neal Batson, *In re Enron Corp*., No. 01-16034 (S.D.N.Y. Bankr. Nov. 4, 2003), at 115.

[19] Ben Heineman, "Heineman on Wells Fargo: Where Were the Lawyers?," *Corporate Counsel* (Oct. 12, 2016).

Tab III: Executive Compensation and Director Pay

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

U.S. Tax Reform: Changes to 162(m) and Implications for Investors

Posted by David Kokell, John Roe, and Kosmas Papadopoulos, Institutional Shareholder Services, Inc., on Thursday, January 25, 2018

Editor's note: David Kokell is Head of U.S. Compensation Research, John Roe is Head of ISS Analytics, and Kosmas Papadopoulos is Managing Editor at Institutional Shareholder Services, Inc. This post is based on an ISS publication by Mr. Kokell, Mr. Roe, and Mr. Papadopoulos.

The Tax Cuts and Jobs Act of 2017 introduces significant changes to Section 162(m) of the Internal Revenue Code, which regulates several compensation-related practices in the United States. The changes raise many questions about how companies will adapt with respect to disclosure practices, general meeting agendas, and—more importantly—pay structures. To help make sense of it all, we turned to David Kokell, Head of U.S. Compensation Research at ISS, who provided insight into how ISS will assess potential changes in compensation practices as a result of the new legislation. Before we delve into the discussion, it is worth reviewing the changes to 162(m) in order to understand their potential impact.

What changed?

Section 162(m) of the Internal Revenue Code of 1986 ("the Code") limits public company tax deductibility for compensation paid to each covered executive to no more than $1 million. However, commission-based compensation and qualified performance-based compensation (including stock options granted at the money) were previously excluded from the $1 million deduction limit; until now. The new law struck the paragraphs describing these exceptions along with the definitions and requirements of what constituted qualified performance-based compensation.

Companies may lose a significant portion of their tax deduction attributable to executive pay, and also the revision removes many provisions that, at least until now, have served as common standards concerning how companies defined and disclosed performance-based compensation. The deleted provisions include:

- **Performance Goals.** To qualify as performance-based under the Code, awards needed to be appreciation based (e.g. stock options or stock appreciation rights) or come with objective goals attached. The goals had to be based on business criteria and on an objective formula. Furthermore, the goals had to be established and disclosed before or soon after the performance period started.
- **Compensation Committee.** The Code required that the performance goals be set and certified by a compensation committee comprising at least two outside directors.

Exchange listing rules later established full-independence requirements for the compensation committee. As such, the committee independence rules are not in question at the moment (at least for companies listed on the major U.S. exchanges).

- **Shareholder Approval Requirements.** Paragraph 4(C) of 162(m), which was struck, included a requirement that "the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration." This was the reason why shareholders were so often asked to vote on cash bonus plans and amendments to equity compensation plans to qualify under 162(m).
- **Maximum Pay and Business Criteria.** The provisions for maximum pay and business criteria were among the "material terms" associated with the shareholder approval requirement. Under the maximum compensation disclosure requirement, companies had to disclose maximum pay upon the achievement of performance goals based on a dollar amount, a formula, or the number of stock-based awards to be granted. The business criteria rules required disclosure of the types of the goals the company used.
- **Stock option and SAR granting terms.** Stock options and stock appreciation rights (SARs)—treated as performance-based under 162(m)—had to be issued with the exercise price at least equal to fair market value to qualify as performance-based. Discounted options became almost extinct in the U.S. market partially due to this provision.

In our interview with David Kokell, his responses offer a perspective on what ISS is hearing on shareholder expectations concerning best practices in executive compensation. It is too early to predict how company practice will change, as interpretation of the new law's impact on 162(m) is not final. Therefore, this discussion does not constitute ISS' official policy in response to the revised tax code. Instead, Mr. Kokell's expert opinion helps position ISS' existing policy framework in the changing landscape.

David, broadly speaking, how do investors view the changes to 162(m)?

David Kokell: 162(m) helped paint the lines on the executive compensation field, defining what was in-bounds and out-of-bounds for executive compensation programs, and providing some transparency and investor control. Some investors fear that the removal of certain 162(m) features may serve to blur those lines, and encourage companies to be less transparent, less objective, less performance-based, and less well-governed around executive compensation than they are today—potentially rolling back significant advances in executive compensation practices gained since the inception of broad say-on-pay in 2011. Many investors will be watching companies closely over the next several years to see how compensation programs evolve under the new regime.

How do you expect the changes to 162(m) to affect proxy season in 2018?

DK: The most immediate change is that we expect to see a decrease in equity plan proposals filed in 2018. Last calendar year, ISS evaluated 740 equity compensation plan proposals at companies in the Russell 3000; 76 of these were placed on the ballot solely (or bundled with minor administrative amendments) to renew the five-year 162(m) deductibility benefit. We expect to see very few similar proposals in 2018. Annual incentive bonus plans may see an even larger impact. In calendar 2017, ISS evaluated 105 amended executive incentive bonus plan proposals, many of which were placed on the ballot to preserve 162(m) benefits. We expect to see a decline in those proposals, as well.

From a pay-for-performance perspective, we don't expect to see changes to materialize frequently in 2018 proxies, perhaps with the exception of certain forward-looking and subsequent-event disclosures.

The new tax law strikes certain sections of 162(m) that defined how the company established performance-based compensation as well as provided requirements around disclosure and shareholder approval of such awards. With these provisions gone, will ISS change the framework of analyzing pay for performance?

DK: In short: no. Investors will continue to expect that executive pay programs emphasize performance-based incentives; that is, awards that are conditioned on the achievement of rigorous and transparent performance goals. The purpose of these awards is both to retain and incentivize management to drive performance that aligns with long-term corporate strategy which, in turn, creates value for shareholders. While the tax deduction for performance pay afforded under 162(m) provided an added benefit, it was seldom a primary reason behind investors' expectation for performance-based programs, or a driving factor in ISS' analysis of pay for performance.

As in previous years, changes that generally reduce the transparent and objective pay-and-performance alignment between shareholders and executives will be viewed negatively when we evaluate compensation pay-for-performance. Negative changes could include material shifts away from performance-based compensation, less transparent disclosure of performance metrics and goals, selecting metrics and setting performance goals later in the performance cycle, and issuing in-the-money stock options.

Speaking of compensation mix, now that the tax deduction exceptions for performance-based pay are eliminated, do you anticipate a shift towards fixed salary or more discretionary pay? How would ISS respond to this type of development?

DK: We've seen at least one high profile company, citing the new tax regime, replace variable bonus opportunities with large guaranteed base salaries. Such a decision effectively eliminates the at-risk nature of pay and severs the linkage between pay and performance. I have no doubt that any board that eliminates or reduces performance-conditioned incentives in favor of guaranteed or highly discretionary pay is going to face investor backlash. ISS will continue to closely scrutinize any decision that diminishes performance pay, and wholesale shifts to fixed pay components will likely result in adverse vote recommendations.

Will ISS change the framework for analyzing equity compensation plan proposals?

DK: Again, in short: no. We will continue to analyze equity plan proposals under the ISS Equity Plan Scorecard, and we will continue to qualitatively evaluate plan amendments as we have for some time. We recognize that with the removal of 162(m) comes the potential for companies to remove shareholder risk-reducing plan features. I would caution companies that may be considering removing these shareholder-friendly features (such as limits on discretion or award caps) from their incentive programs simply because they are no longer required under 162(m). ISS, and many investors, will view such actions as detrimental to shareholders' interests. In fact, some investors would prefer to see a move to adopt overall individual award limits (covering all award types in a plan).

Newly-IPO'd companies also may present new shareholder challenges. In the past, to maintain 162(m) benefits, those newly-IPO'd companies were required to take equity plans to investors for approval (approximately) three years after their IPO. In many cases, companies used this occasion to update their pre-IPO plans, often installing features more beneficial to shareholders and removing features that tend to be problematic (such as evergreen share pools). In the new regime, these pre-IPO plans may survive for many years—up to close to ten years in some cases—after the IPO. We are carefully considering how to handle these situations in the future.

In the absence of a code of best practice in the United States, the recently eliminated provisions of 162(m) for performance-based awards helped set some minimum standards. Which of these standards would you consider best practices in performance-based pay?

DK: While incentive plan designs can vary dramatically company to company, there are a number of features and practices that are routinely recognized by investors as good or best practices. Many of these practices were already embedded in Section 162(m)'s requirements for qualifying performance-based compensation. The requirement that awards be contingent on the attainment of pre-established performance goals remains paramount. Investors also tend to prefer an objective payout formula with performance goals established early in the performance measurement period. I would also stress that setting individual award caps and limiting the ability for upwards discretion on payouts will also be viewed as important safeguards. That said, we've heard from some investors that they have comfort with some level of discretion embedded in programs, as long as that discretion is applied judiciously and is well-explained.

The new law took effect on January 1, 2018. In anticipation of the new rules, companies had an incentive to accelerate the accrual of deductions for cash bonuses or restricted stock awards into 2017. Will such actions raise concerns?

DK: In general, the acceleration of awards absent a qualifying termination is considered a poor practice, since it effectively removes the retention and incentive components inherent in vesting criteria. Boards must weigh this risk against the benefit of taking final advantage of the more favorable tax treatment.

That being said, we are aware that some companies have accelerated the payout of awards to the end of 2017 that were originally due to be paid in early 2018. I don't foresee acceleration of payouts by only a few weeks as being viewed as problematic by most investors. However, many investors will undoubtedly object to the acceleration of awards otherwise due to be paid later in 2018 or, even worse, in subsequent years.

Do you have any final thoughts for investors and companies as they formulate their strategy in the absence of certain 162(m) provisions?

DK: For companies, think carefully about significant departures from your existing compensation framework and, to the extent possible, test those changes with your shareholder base to get early feedback whether they view the changes as beneficial. And for investors, given that the proactive portion of shareholder engagement season for most issuers is drawing to a close, consider making your views known publicly and communicate them to other shareholders. Now is when those compensation program and award decisions are being made, and now is when the opportunity to influence outcomes is high.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

The Impact of Pending Tax Reform on Executive Compensation: The Need for Deductive Reasoning

Posted by Holly M. Bauer, Michelle L.C. Carpenter and Austin Ozawa, Latham & Watkins LLP, on Wednesday, December 27, 2017

Editor's note: Holly Bauer, Michelle Carpenter and Austin Ozawa are partners at Latham & Watkins LLP. This post is based on a Latham publication by Ms. Bauer, Ms. Carpenter, Mr. Ozawa, James D.C. Barrall, and Nikhil J. Kumar.

Proposed US tax reform may impact the deductibility of executive compensation programs and companies should evaluate any potential tax planning opportunities in 2017 and the impact of the proposed changes going forward.

The US House of Representatives and the Senate continue to work to reconcile the two versions of the Tax Cuts and Jobs Act (the Bill) previously passed in each chamber. However, both versions make significant changes to a public company's ability to deduct compensation paid to certain of its executive officers and other changes that will impact future executive compensation.

The major changes are:

- Repealing the exceptions for "performance-based compensation" under Section 162(m),[1] thereby rendering all compensation paid to a "covered employee" that is greater than US$1 million per year non-deductible.
- Expanding the scope of "covered employees" to include the principal financial officer. This expansion also provides for continued application of Section 162(m)'s deduction limitations to any compensation paid to an individual who is a covered employee at any time on or after January 1, 2017 (even after termination of employment).
- Expanding the scope of corporations to which Section 162(m) would apply to include those with publicly traded debt, and potentially also to foreign private issuers.

Under both versions of the Bill, these changes will be effective for tax years beginning on or after January 1, 2018. Companies that could be affected by these changes (essentially, all companies with publicly traded securities or debt in the US) should analyze the impact of the proposed changes on their executive compensation program prior to year-end, and consider whether they should take any proactive measures.

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended.

Additionally, the Bill would change tax rates and could eliminate deductions for state and local income taxes. This will affect executive compensation taxation in years to come and will require continuing consideration after 2017.

Year-End Planning Considerations

Public companies may want to evaluate whether to accelerate certain executive compensation payments into 2017 to take advantage of current tax rules, including the certainty of deductibility under Section 162(m) this year. In doing so, companies should keep the following points in mind.

Company Deductions

Due to the proposed reduction in the corporate tax rate under both versions of the Bill, deductions taken in 2017 could be more valuable to companies than those taken in 2018. Companies may want to consider securing compensation deductions in 2017, if possible. For example, companies that normally would not be able to deduct 2017 bonuses (such as those that require employment on the date of payment in 2018) may have an opportunity to secure a deduction in 2017 for that compensation by accelerating payment of cash bonuses into 2017. Alternatively, companies could establish a minimum bonus liability under bonus plans by year-end to secure 2017 deductions. Similarly, companies could consider accelerating the vesting and/or payment of equity awards that otherwise would have been vested and/or paid in 2018 into 2017. Companies would need to ensure actions would not run afoul of the Section 162(m) performance-based compensation requirements, such as the need to certify actual performance through the performance period prior to payment, or constitute impermissible accelerations under Section 409A. Various technical requirements under tax and accounting rules also apply to ensure the acceleration of the timing of the deduction will be honored.

"New" Covered Employees For 2018

As noted above, under both versions of the Bill, a public company's principal financial officer will be a "covered employee" subject to Section 162(m)'s deduction limitations for future tax years. Because a company's principal financial officer is not considered a "covered employee" under the current rules, companies should consider accelerating compensation payable to their principal financial officers in 2018 into 2017. This would ensure a deduction for such payments to the extent the officer's 2018 compensation is expected to exceed US$1 million. Likewise, if a company employs an individual who currently would be a covered employee for 2017 but for the fact he or she ceased to be a covered employee prior to the last day of the 2017 taxable year (due to termination of employment or change in position, for example), that individual will continue to be a covered employee going forward under the Bill. If such a terminated executive is expected to receive compensation in excess of US$1 million during 2018, accelerating those payments into 2017 could have a tax benefit for the company.

Executive Deductions

Under both versions of the Bill, individuals will no longer be able to deduct state and local income taxes on their federal income tax returns. Consequently, executives (particularly those residing in states with high state income tax rates, such as California and New York) may be interested in accelerating the taxation of certain compensation into 2017 to ensure they can deduct the state and local income taxes on such payments. There are a number of technical tax and accounting requirements to ensure the acceleration of the timing of the deduction will be honored. For example, employers may need to actually issue checks for early bonus payments or deliver shares for acceleration of equity awards prior to the end of the day on December 31, 2017, ensuring the deduction can be taken in 2017 (approval of these payments may not be sufficient).

Transition Relief

The Senate version of the Bill contains transition relief for certain Section 162(m) performance-based compensation arrangements pursuant to "written binding contracts" in effect as of November 2, 2017, so long as such arrangements are not "modified in any material respect."

Whether the transition relief will be included in any final Bill is unclear, however, companies will want to tread carefully to ensure that their actions will not adversely affect any "grandfathering" of existing Section 162(m) performance-based compensation arrangements.

Reviewing Plan Documents and Proxy Disclosures

As always, companies should carefully review their plan documents and proxy disclosures. Companies should pay particular attention to those made in connection with obtaining shareholder approval for the plans, to confirm that any contemplated changes in payment timing or processes have been duly authorized and are consistent with the terms of the plans and disclosures.

Moving Forward Under New Rules

Even if the Bill is enacted and the Section 162(m) changes survive in substantially the forms the House and Senate have passed to date, US public companies will undoubtedly continue to rely on performance-based compensation as a component of their executive compensation programs, due to the need to ensure proper incentives for executives and that shareholders and proxy advisory firms will continue to demand that executives' compensation pay for performance and be aligned with investor interests. That said, compensation (including performance-based compensation) in excess of US$1 million that is paid to a covered employee will be non-deductible. As a result, the design and implementation of performance-based compensation arrangements will be possible without regard to the highly technical and prescriptive requirements of Section 162(m).

Even if the Bill is enacted, it likely will take months before the ultimate impact of the final Bill on Section 162(m) is known. The Department of Treasury will issue regulations on the final Bill, but the timing is unknown. However, even in the absence of final guidance, the proposed changes to Section 162(m) will impact US public companies in some of the following ways, each of which will require careful consideration:

Reevaluate and Reconsider Performance-Based Compensation Designs

- Performance-based compensation programs will be able to use any performance metrics the compensation committee deems appropriate, and will not be limited to the shareholder-approved performance goals.

- The compensation committee can retain negative or positive discretion on any final payouts (currently, only negative discretion is allowed).
- Adjustments to performance goals will not need to be objective and specified in advance—the compensation committee will have the ability to adjust performance goals as it deems appropriate, to match a company's actual business results and unexpected circumstances.
- Stock options and stock appreciation rights no longer will receive preferential treatment under Section 162(m) as performance-based compensation and other award types may become even more popular, as they will no longer be disadvantaged from a deductibility perspective.
- Companies may want to consider modeling different vesting and payment timing to enhance the deductibility of equity (and other incentive) compensation, such as longer vesting periods to spread out the income realized from equity awards over a greater number of calendar years.

Reevaluate Severance and Equity Acceleration Provisions

Currently under Section 162(m), compensation fails to qualify as performance-based compensation if such compensation is payable without regard to whether the underlying performance goals are attained in the event of a termination without cause, a resignation for good reason, or retirement. For example, under the current rules, a severance arrangement providing for payment of a covered employee's target bonus for the year of termination without regard to actual performance would render any annual bonus payable to such employee as ineligible for the Section 162(m) performance-based compensation exception, regardless of whether the termination provision was triggered. Under both versions of the Bill, companies can revisit these provisions.

Consider Equity and Cash Bonus Plan Amendments

Equity plans typically contain extensive provisions designed to ensure that equity awards can qualify as performance-based compensation for Section 162(m) purposes. These include individual limits on the number of shares and/or amount of cash that companies may pay to individuals during a specified time period. If the performance-based compensation exception is eliminated, equity plans could be amended to remove these provisions. Whether shareholder approval of any such amendments is required will largely depend on the equity plan's amendment language and applicable national stock exchange rules on equity plans. How the proxy advisory firms will view proxy proposals to amend plans to remove Section 162(m) provisions remains unclear. The stock exchanges may also weigh in on whether such amendments will require shareholder approval. Companies may also need to update equity plan prospectuses if they include tax disclosure regarding Section 162(m). Companies maintaining cash bonus plans with Section 162(m) provisions may also want to revisit or discontinue those plans in favor of more flexible arrangements.

Consider Covered Employee Group Expansion

Companies will want to ensure they understand who their covered employees will be for 2018 and beyond, so that their compensation committees can make informed executive compensation decisions. Additionally, companies may want to consider ensuring their executive officer list is as narrow as possible, while still complying with securities law requirements (as the determination of the covered employee list will be based on the executive officer list).

Review Compensation Committee Membership

Although the national stock exchanges and securities laws still impose requirements on compensation committee member qualifications, compensation committee members would no longer need to qualify as "outside directors" for purposes of Section 162(m). Under the transition relief, it may be necessary to ensure compensation committee members satisfy the Section 162(m) requirements until any grandfathered awards are certified and paid. Companies that have used subcommittees of the compensation committee to approve performance-based compensation (because a member of the compensation committee was not an "outside director") will be able to disband such subcommittees once they are no longer needed under any transition relief.

Reevaluate Compensation Committee Charters

Companies may need to amend compensation committee charters to remove references to Section 162(m).

Consider Section 162(m) Transition Periods

How the Bill will affect existing transition periods under Section 162(m) (such as after an initial public offering or a spin-off) is unclear at present. Companies that are in such a transition period will want to monitor the rules and confirm with their legal, tax, and accounting advisors how the final rules will affect their executive compensation deductions.

The Bottom Line

Companies should consult with their legal, tax, and accounting advisors to determine whether any year-end actions are possible or advisable to maximize deductions for executive compensation and to mitigate tax costs to executives, given, the proposed changes to Section 162(m), the proposed reduction in the corporate tax rate for future tax years, changes in individual tax rates and deductions under the Bill, and the need to navigate requirements under Section 409A and securities laws.

Companies must also consider the effect of any actions on existing Section 162(m) performance-based compensation arrangements under the proposed transition rules. However, in many cases, the reduced corporate tax rate may somewhat offset any lost deduction in 2018 due to Section 162(m) changes. Companies should account for this in evaluating the relative costs (including administrative time and effort) and benefits of any 2017 year-end machinations to accelerate company deductions. Ultimately, the value of accelerating the deduction for executive compensation will depend on a company's particular tax situation.

If the Bill is enacted and Section 162(m)'s scope is expanded as proposed, US public companies will also want to review their existing executive compensation program, plans, and arrangements and consider whether any adjustments are desirable or, potentially, required in order to accommodate the new realities and to maximize their alignment with company and shareholder interests.

2017 Proxy Season Review: Compensation

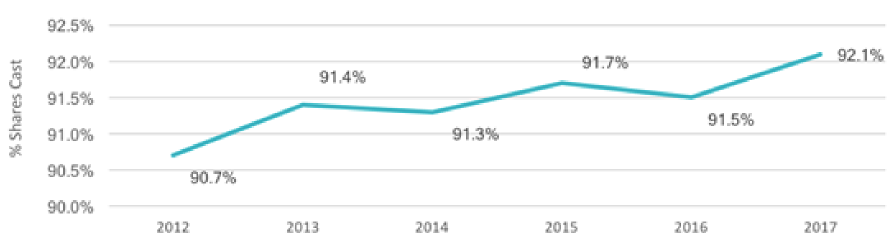
Posted by Subodh Mishra, Institutional Shareholder Services, Inc., on Friday, October 6, 2017

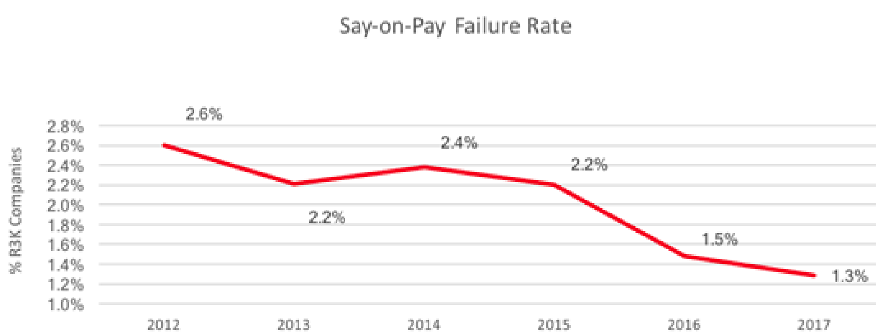
Editor's note: Subodh Mishra is Executive Director at Institutional Shareholder Services, Inc. This post is based on an ISS publication.

In early September, ISS published its annual post-season report on compensation vote results and practices, which revealed a continuation of many trends identified last year. Shareholder support for management say-on-pay remains stronger than ever, while failures are exceedingly rare; average support for equity plan proposals was consistent with prior years. While CEO pay at larger companies has increased, the composition of CEO pay packages has trended towards more strongly performance based incentives. Interestingly, median golden parachute payments rose considerably, while golden parachute vote rates dropped and failure rates more than doubled. Shareholder proposals on compensation topics remained on the decline, and for the second consecutive proxy season no proposals received majority support.

Say-on-Pay Votes

Say-on-pay support reached its highest levels. Since the introduction of say-on-pay, average support levels have remained consistently high. The 2017 proxy season was no exception, with average vote support of 92.1 percent, the highest to date. Failed votes remained a rare occurrence and the failure rate of 1.3 percent for 2017 was the lowest yet.



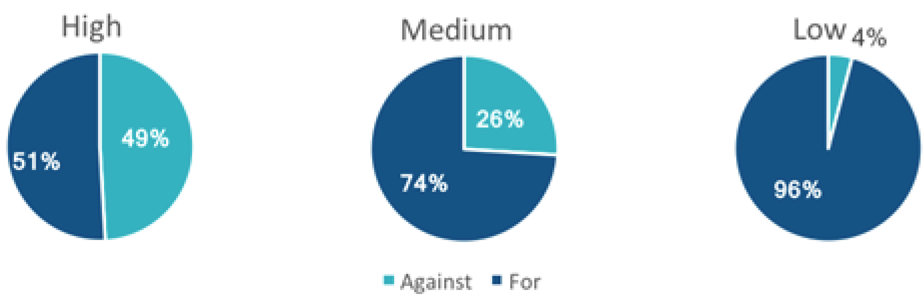


Votes Cast For / Votes Cast For + Against. Unless otherwise indicated, charts represent companies in the Russell 3000 Index (R3K), inclusive of the S&P 500 Index (S&P 500), with annual meetings held between January 1 and June 30.

ISS Recommendation Trends

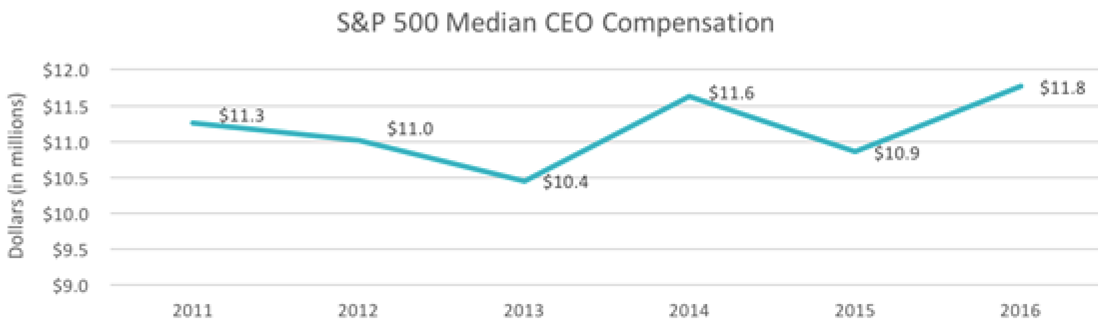
The severity of pay-for-performance misalignment correlates with ISS vote recommendations. During the first half of 2017, ISS recommended “against” votes for nearly half of the companies where there was a “High” quantitative concern, which indicates a severe misalignment between pay and performance. ISS recommended against slightly more than one-quarter of companies with a “Medium” concern level. Only 4 percent of companies that yielded a “Low” quantitative concern level (indicating quantitative alignment) received “Against” recommendations, usually as a result of problematic contractual provisions or poor board responsiveness. The initial screens identify quantitative outliers, while the ultimate say-on-pay vote recommendation is based on an in-depth qualitative assessment of pay programs and practices.

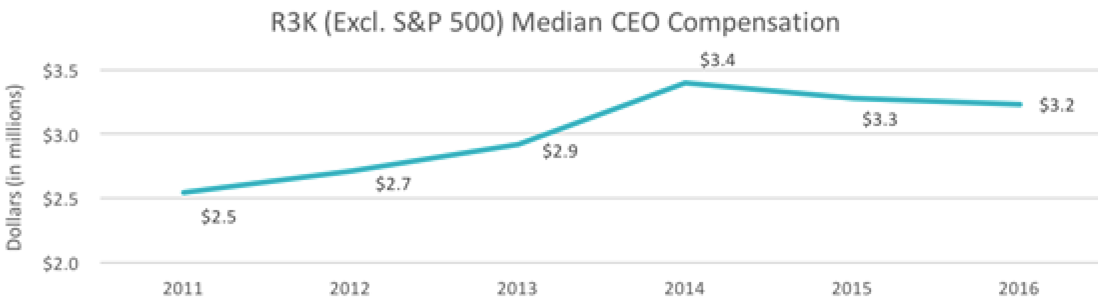
ISS’ Say-on-Pay Recommendations by Quantitative Concern Level 2017



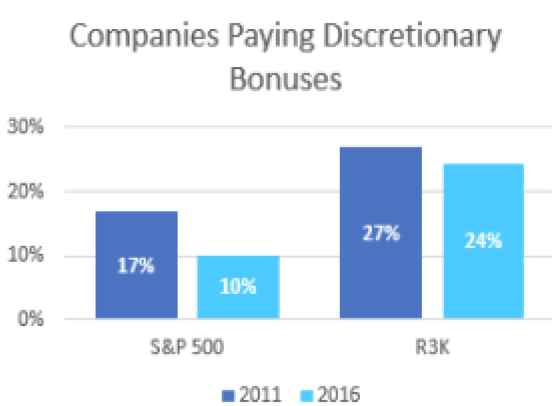
CEO Pay Trends

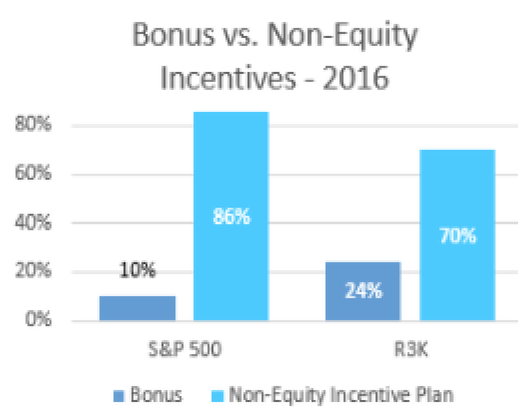
Median S&P 500 CEO pay reached its highest point since the say-on-pay rule took effect in 2011, pay at smaller companies was flat. Median CEO compensation in the S&P 500 grew nearly 8 percent over 2015 (including the impact of cash, stock awards, pensions, and other compensation), driven primarily by increases in stock compensation. Median CEO pay in the Russell 3000 (exclusive of the S&P 500) declined slightly from $3.28 million to $3.24 million. For these smaller companies, CEO total pay has remained relatively steady over the past three years.



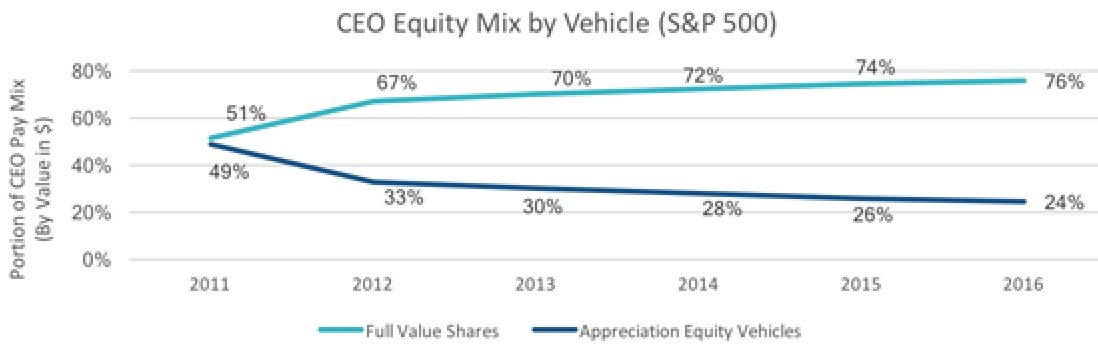


Discretionary bonuses continued to decline. Companies paying discretionary cash bonuses to the CEO (as disclosed in the "Bonus" column of the Summary Compensation Table) made up an even smaller minority in both the S&P 500 and the Russell 3000. In 2016, just 10 percent of the S&P 500 and less than a quarter of R3K companies paid discretionary cash bonuses. Concurrently, more companies are moving to formulaic non-equity incentive programs. In 2016, 86 percent of the S&P 500 and 70 percent of the R3K reported payments to the CEO through non-equity incentive plans.

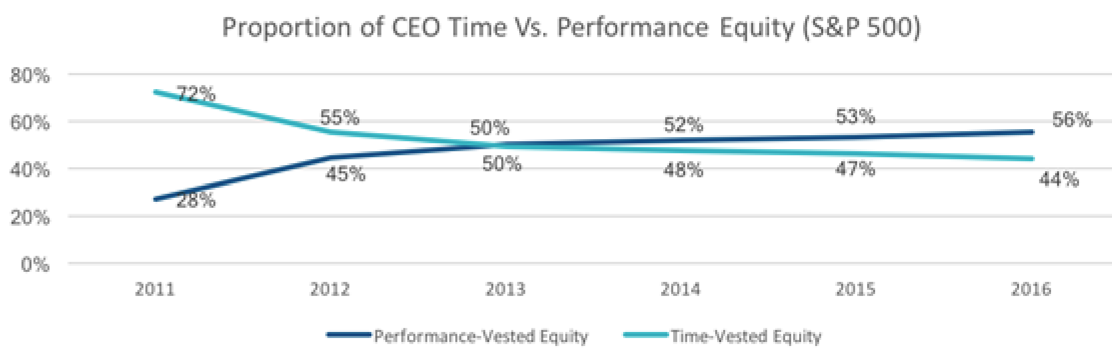




Appreciation awards continue to decline in popularity. The use of appreciation awards (options and SARs) for CEOs in the S&P 500 continued to decline in 2016, and these were increasingly replaced with full value share awards (restricted stock and RSUs, both time- and performance-vested).

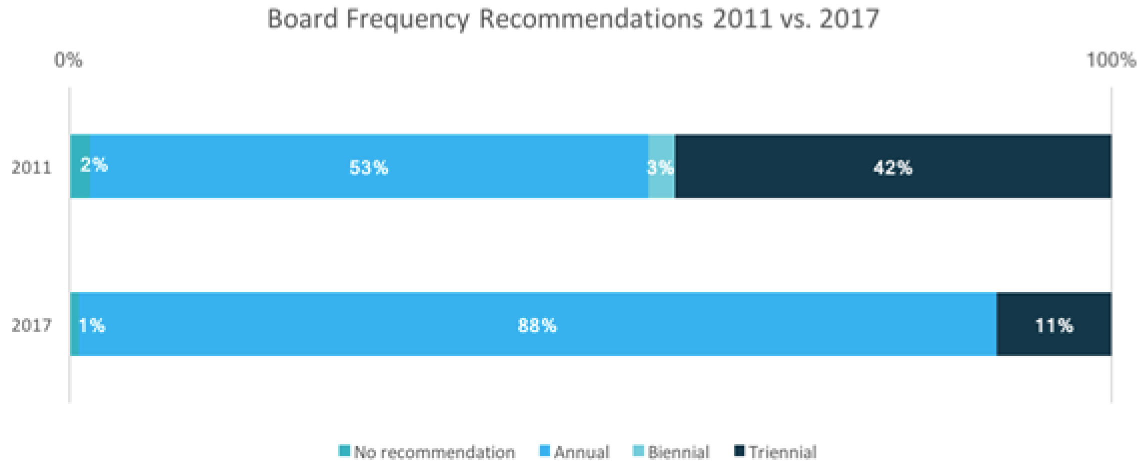


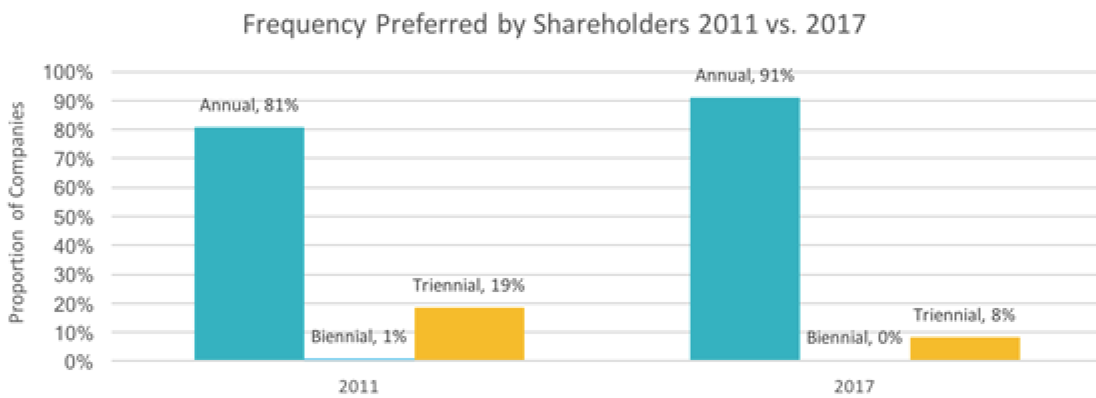
Performance-conditioned equity is the prevailing practice. Among the S&P 500, most companies deliver the majority of CEO equity awards in performance-conditioned vehicles. The percentage of CEO performance equity increased further in 2016 to an all-time high of 56 percent.



Say-on-Frequency Votes

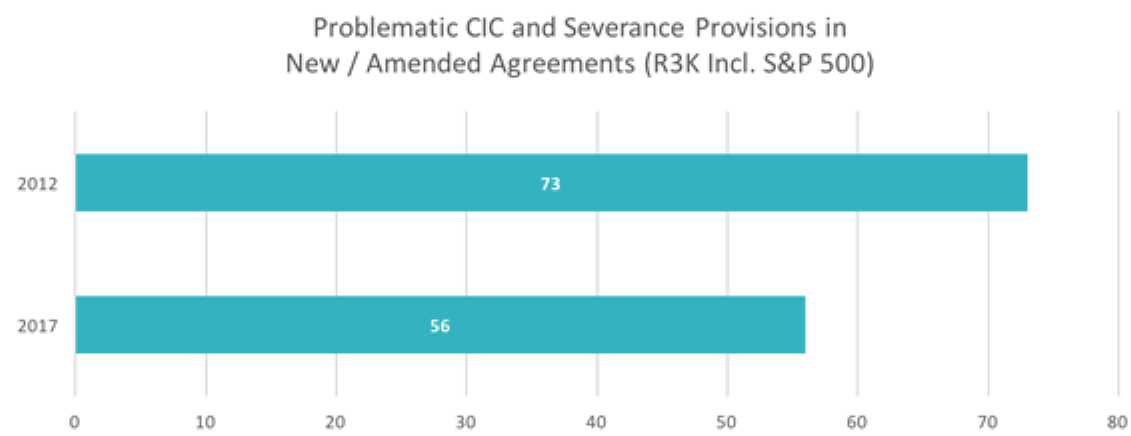
Say-on-pay frequency votes returned; annual frequency favored by boards and investors. Say-on-pay frequency votes are required at least once every six years, and most companies held their second say-on-pay frequency vote during the 2017 proxy season. In this second wave of frequency votes, significantly more boards supported an annual frequency. During the 2017 proxy season, 88 percent of boards recommended annual votes, compared to 53 percent in 2011. Shareholders' strong preference for an annual frequency was even more pronounced in 2017, as they endorsed an annual frequency at 91 percent of companies in 2017, compared to 81 percent in 2011.





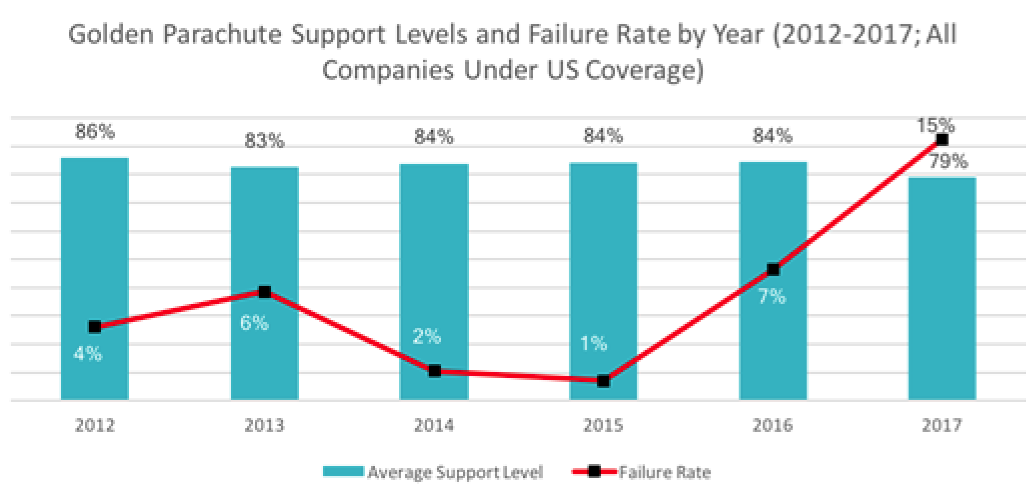
Problematic Pay Practices

Problematic pay practices are generally declining. The number of problematic severance and change-in-control provisions (per ISS policy) that were included in new or materially amended executive agreements has declined each year, as illustrated below. However, the decline has recently slowed: this year 56 companies included such provisions in new or amended agreements, compared to 58 in 2016. Excise tax gross ups were the exception to this trend, and actually grew more prevalent in 2017.



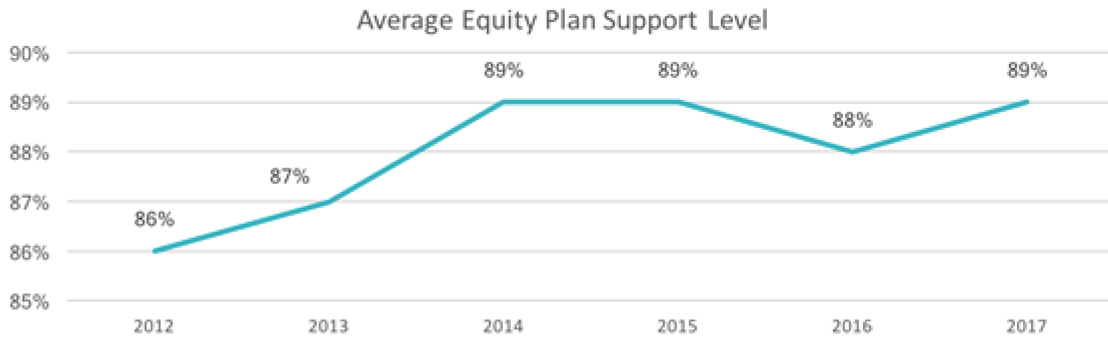
Say-on-Golden Parachute Votes

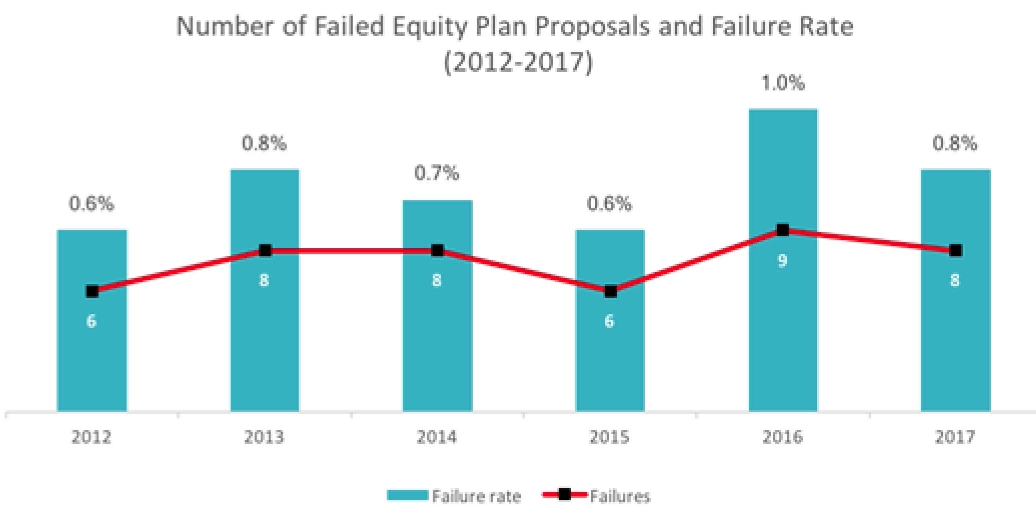
Golden parachute failure rate doubled as average shareholder support fell. Shareholder support for golden parachute proposals has typically trended lower than say-on-pay support. Average support for golden parachute proposals fell to an all-time low of 79 percent in 2017. The number of failed proposals doubled from six proposals in the first half of 2016 (7 percent of all proposals) to 12 proposals (15 percent) in 2017. As companies continue to incorporate performance equity awards, ISS and shareholders are more closely scrutinizing vesting treatment upon a change in control, particularly for recent grants. Moreover, the median CEO golden parachute payment rose by close to 75 percent, from $5.2 million in 2016 to $9 million in 2017.



Equity Plan Proposals

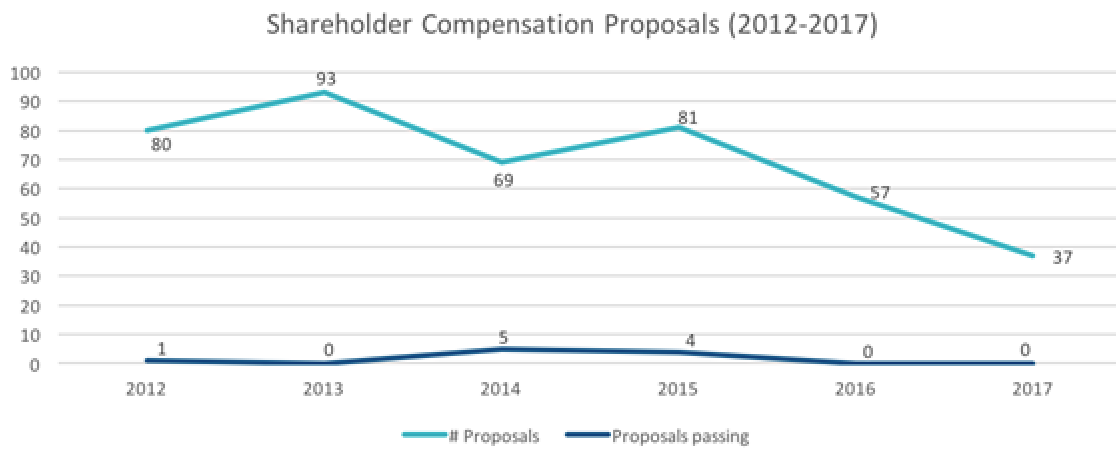
Equity plan support levels were essentially flat. For the 2017 proxy season, average equity plan support was 89 percent, consistent with recent years. ISS supported 70 percent of the equity plan proposals analyzed under U.S. policy in 2017, a slight increase from 68 percent in 2016. Eight equity plan proposals failed, just below the five-year high of nine failures seen in the 2016 season. While there was no single common factor resulting in the failed proposals, many of the evaluated plans showed a relatively high shareholder value transfer (plan cost).





Shareholder Proposals on Compensation

The number of shareholder proposals on compensation plummeted. Shareholders voted on 37 compensation-related proposals during the 2017 proxy season, the lowest number since the first full year of say-on-pay. Compensation shareholder proposals rarely receive majority support and, similar to last year, none did during the 2017 proxy season. The steadily declining number of compensation-related shareholder proposals is likely impacted by the introduction of say-on-pay, which provides shareholders an alternative channel to voice their concerns.



Shareholder Compensation Proposals (2012-2017)
100
90
80
70
60
50
40
30
20
10
0
80
93
69
81
57
37
1
0
5
4
0
0
2012
2013
2014
2015
2016
2017
Proposals
Proposals passing

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S&P 500 CEO Compensation Increase Trends

Posted by Aubrey E. Bout and Brian Wilby, Pay Governance LLC, on Saturday, October 7, 2017

Editor's note: Aubrey E. Bout is Managing Partner and Brian Wilby is a Consultant at Pay Governance LLC. This post is based on a Pay Governance publication by Mr. Bout, Mr. Wilby, and Perla Cruz.

CEO pay continues to be a widely debated topic in the media, in the boardroom, and among investors and proxy advisors. As the U.S. was in the heart of the 2008-2009 financial crisis, CEO total direct compensation (TDC; base salary + actual bonus paid + value of long-term incentives [LTI]) dropped for 2 consecutive years. As the U.S. stock market sharply rebounded and the economy started to slowly grow again, CEO pay also rebounded. Large pay increases occurred in 2010, primarily in the form of larger LTI grants. Since then, year-over-year increases have been fairly moderate—in the 2% to 6% range for 2011-2016.

We expect that 2017 CEO TDC will likely be up in the mid-single digits (at the upper end of the recent range or slightly higher) based on past pay trends, accelerated earnings growth projections, a relatively stable global economic environment, and preliminary signs of a growing U.S. economy. Executives in industries with favorable economic conditions and higher growth will more likely see bigger pay increases than those in slow-growth industries.

Executive Summary

- Annual CEO pay among S&P 500 companies has been increasing by the low- to mid-single digits over the last 6 years.
- Historical CEO pay increases have been supported by total shareholder return (TSR)—in fact, annualized pay increases have been 9 percentage points lower than TSR performance.
- We expect that current year (2017) CEO pay will be up in the mid-single digits, given expected revenue and earnings growth achievements and strong TSR performance among S&P 500 companies (year-to-date TSR through September 15 was 13%)
- We expect CEO pay to continue to be a closely monitored topic with the likely implementation of the CEO pay ratio, while we expect that institutional investors will continue to support current pay models at the vast majority of companies despite continued proxy advisor scrutiny.

Historical Trend in CEO Pay and LTI Vehicles

CEO pay rebounded 31% in 2010 after 2 consecutive years of -9% and -13% decreases during the financial crisis of 2008 and 2009, respectively (source: Equilar CEO Pay Trends annual reports). Since then, year-over-year pay increases have been fairly moderate—in the 2% to 6% range (Figure 1).

It is not surprising that CEO pay has slowed recently, given that S&P 500 revenue and earnings growth has been anemic in recent years—in 2016, CEO pay increased 4% while S&P 500 Index revenue and earnings before interest, taxes, depreciation, and amortization (EBITDA) growth were 1.8% and 0.9% in 2016, respectively. The lack of robust earnings growth has translated to lower actual bonuses, partly offset by slightly higher salaries and LTI grant values.

Over the last several years, LTI vehicle usage has shifted away from stock options, mostly in favor of performance-based plans that pay based on performance versus goals. From 2009-2016, performance share prevalence increased from 50% to 88%, stock options decreased from 70% to

59%, and restricted stock increased from 46% to 59% (Figure 2). The rise in performance-based plans can largely be attributed to proxy advisors and some shareholders considering performance share plans, and not stock options, as performance-based.

Figure 1:

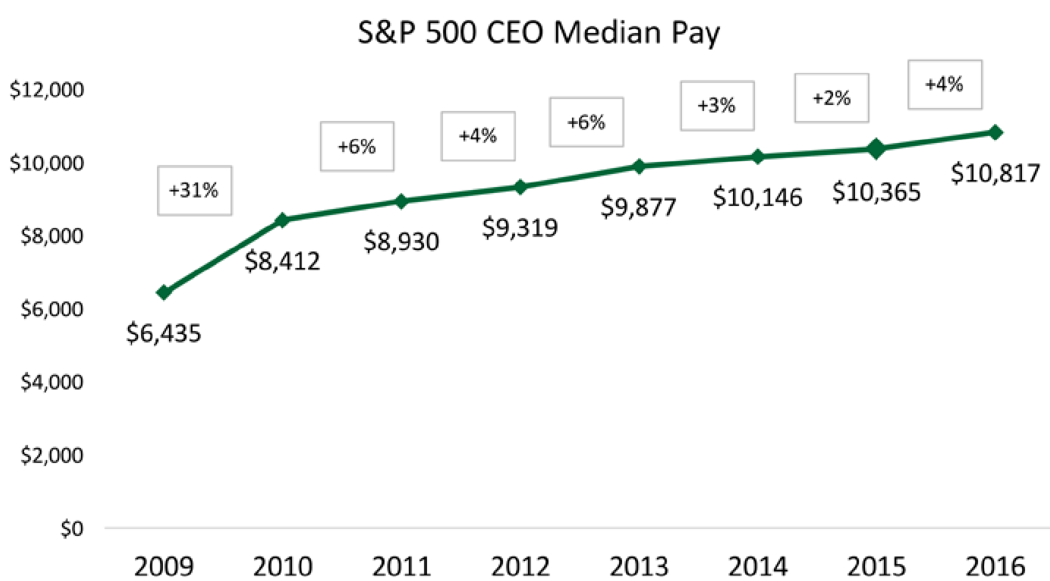


Figure 2:

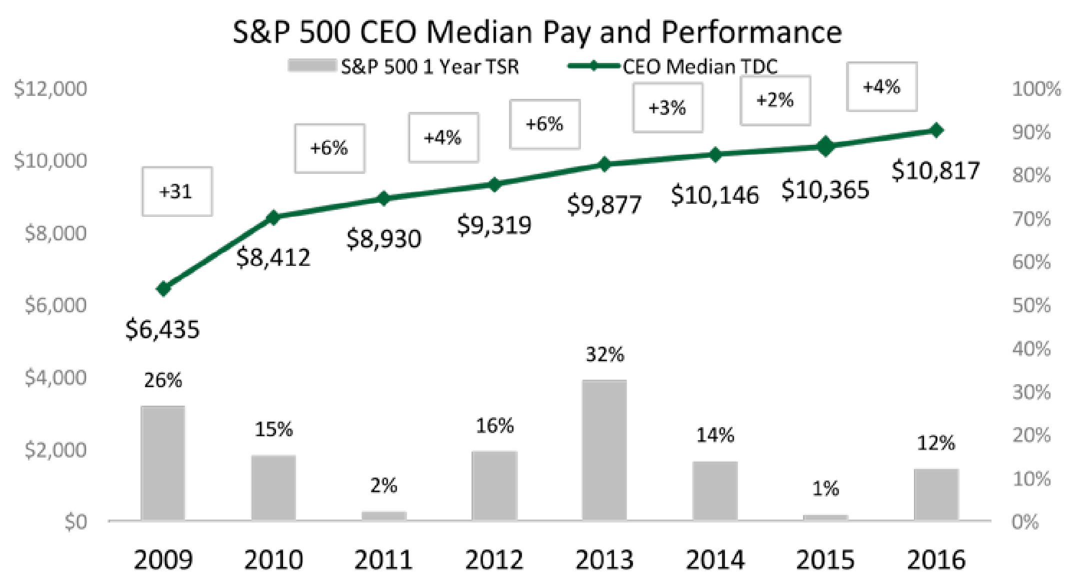
Year	LTI Vehicle Prevalence for S&P 500		
	Performance Plan	Stock Options	Restricted Stock
2009	50%	70%	46%
2012	71%	61%	51%
2016	88%	59%	59%

Trend in CEO Pay versus S&P 500 Index Performance

CEO pay increases have been supported by strong total shareholder return (TSR)—in fact, pay increases over the last 7 years have trailed TSR performance by ~9% based on the Compound Annual Growth Rate. Figure 3 demonstrates that in every year that TSR increased, CEO pay increased. The increases were not always proportionate: in each of the last 6 years (2011-2016), annual pay increases were ≤6%, while the S&P 500 total return ranged from 1% in 2015 to 32% in 2013.

There is clear positive correlation between share price performance and CEO pay. In a positive stock price environment, Compensation Committees are often more supportive of CEO pay increases, typically delivered in the form of larger LTI grants. CEO base salaries sometimes only periodically increase (i.e., less than an annual basis) and typically only make up a small portion of the executive pay package. Annual actual bonuses, though not as large as the LTI portion, can have a meaningful impact on whether year-over-year pay increases. When a company is having a good year and exceeding budget goals and investor analyst expectations, the CEO bonus often pays above target and increases year-over-year (often, the share price also increases as company performance is strong). That said, there will be some years where a CEO's bonus pays above target as the company exceeded its budgeted goals, while the share price goes down due to stock market volatility or correction and sector rotation. The opposite also can happen: goals are not met, resulting in lower bonuses, while the stock market goes up.

Figure 3



CEO Pay Projections

1. We expect overall 2017 CEO TDC to increase by the mid-single digits for many executives in most industries, assuming 2017 profits increase as projected in the low-double-digit range in aggregate.
   a. Our research suggests that CEO pay increases have been lower in recent years (Figure 1); however, if companies deliver on strong 2017 earnings forecasts, we could see a marked increase in CEO pay.
   b. Aggregate S&P 500 Index year-over-year revenue and EBITDA for 2017 are forecasted to increase by 7-9% and 14-18%, respectively (based on data sourced from S&P Capital IQ). The energy sector and profitability rebound contributed to higher forecasted growth rates overall.
   c. EPS forecasts for 2017 are currently showing major growth over 2016, suggesting that significant macroeconomic and political expectations are included in current equity valuations.
   d. While strong earnings growth may support higher executive pay increases, the media, CEO pay ratio implementation, and proxy advisor scrutiny will continue to exert negative pressure.
   e. Although voluntary CEO turnover is very low, the increasingly tight labor market and luring away of high-profile sitting CEOs (e.g., Dara Khosrowshahi from Expedia to Uber) might make some Board members nervous about losing their current strong performing CEO; this may translate to larger pay increases in the future.
2. In certain industries, such as biotechnology or information technology, executives may experience continued faster growth in total compensation this year, while executives in slow-growth industries might see smaller increases.
3. We expect general industry executive target pay TDC levels to up in the mid-single digits in 2017 and 2018 due to meaningful earnings increases expected for 2017 supported by strong TSR performance. The exception would be for executives who outperform their peers and exceed company goals—those CEOs might see larger pay increases than the norm.

The above pay projections do not account for any potential market setbacks (e.g., nervousness about geopolitical uncertainty, dramatic changes in the economic environment, unexpected changes in the Federal Reserve's interest rate policies, or significant drops in the overall stock market).

Methodology

The CEO pay analysis consists of S&P 500 companies that have CEOs with a ≥3-year tenure. Pay data includes base salaries and bonuses paid for each year as well as the reported grant date fair value of LTI awards. Our analysis of consistent incumbent CEOs was designed to highlight true changes in CEO compensation (as opposed to pay changes driven by the new hiring or internal promotion of CEOs, which typically involves ramped-up pay over a period of 2-3 years).

Note on Realizable Pay

It is important to note that our methodology used year-over-year CEO pay and was based on the accounting value of LTI as reported in proxy summary compensation tables. These amounts are more akin to pay opportunity and are quite different from realizable pay, which includes in-the-money value of stock options, ending period value of restricted stock, and estimated value of performance shares. Pay Governance's past research has shown there is a very strong correlation between realizable pay and TSR performance. While we have shown there is a positive correlation between CEO annual pay increases and TSR performance, we are confident the correlation is not as high as that between realizable pay and TSR increases.

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The Evolution and Current State of Director Compensation Plans

Posted by John Ellerman, Peter England, and Blaine Martin, Pay Governance LLC, on Tuesday, September 5, 2017

Editor's note: John Ellerman is a partner, Peter England is a consultant, and Blaine Martin is a consultant at Pay Governance LLC. This post is based on a Pay Governance publication by Mr. Ellerman, Mr. England, and Mr. Martin.

Over the past 20 years, there has been a major shift in how large public companies have compensated their outside Directors.[1] These changes have included the elimination of Board meeting fees, granting of equity compensation in the form of full-value shares, the elimination of Director retirement plans and other perquisites, adoption of stock ownership guidelines for Directors, and giving of supplemental cash retainers to Committee Chairs in recognition of their substantial time commitments to committee work.

A recent Pay Governance review of Director compensation among S&P 500 companies reveals that these trends have become embedded in the policies and compensation in large U.S. companies.[2] The survey, which reports 2016 Board compensation, shows that the median total direct compensation awarded to an S&P 500 corporate Director was $265,487. This represents a <1% (i.e., 0.5%) annual compensation increase for 2016 compared to 2015.

2016 Competitive Data—S&P 500 Director Compensation[2]

Compensation Element	Prevalence	Median
Cash Retainer	98%	$90,000
Board Meeting Fees	19%	$2,000 per meeting
Equity Award	99%	$150,000
Audit Chair Retainer	95%	$20,000
Comp Chair Retainer	93%	$20,000
Governance Chair Retainer	88%	$15,000

[1] Diane Lerner. "Board of Director Compensation: Past, Present and Future." Pay Governance LLC Viewpoint. 2016. http://paygovernance.com/board-of-directors-compensation-past-present-and-future/, discussed on the Forum here.

[2] Sample reflects most recently available fiscal year data, generally FY2016. Data provided using Main Data Group.

Lead Director Retainer	84%	$30,000
Audit Member Retainer	43%	$12,500
Comp Member Retainer	31%	$10,000
Governance Member Retainer	29%	$8,000
Total Direct Compensation	**100%**	**$265,487**
Cash/Equity Mix	N/A	41% Cash/59% Equity

In this post, we examine each of the 5 policies/practices cited above and discuss our findings for FY2016 Board pay.

(1.) **Companies have mostly eliminated Board meeting fees**. Over the course of the past 5 to 7 years, more and more companies have stopped paying meeting fees for regularly scheduled Board of Director meetings, and have instead increased annual cash retainers paid to Directors. Only 19% of S&P 500 companies report paying separate meeting fees for each Board meeting attended. The aforementioned S&P 500 survey reported the median annual cash retainer at $90,000 in 2016. Similar to the shift away from Board meeting fees and to service-based retainers, only 21% of S&P 500 companies provide meeting fees for attendance at Committee meetings, and instead compensate Directors through the Board retainer or supplemental Committee member retainers.

Some companies provide supplemental meeting fees for an abnormally high number of Board meetings in a particular year. We found that the median number of S&P 500 Board meetings is 7 per year; some companies provide a supplemental $2,000 fee for each meeting held in excess of 10 per calendar year, for example.

(2.) **Equity grants are in full-value shares**. Full-value shares (in the form of stock grants, restricted stock, restricted stock units, or deferred stock units) are granted to 96% of S&P 500 company Directors annually. Only 12% of S&P 500 companies grant stock options to non-employee Directors, including some companies which grant stock options in concert with full-value shares. As with executive long-term incentive practices, stock options have lost favor, having failed to recover from the “black eye” attributed to egregious stock option practices in the early 2000’s. Our S&P 500 review found that the median value of annual grants to Directors was $150,000 in 2016, and that most companies use a fixed dollar approach as opposed to a fixed number of shares in determining the size of annual grants. Further, the mix of cash versus equity is now denominated in 41% cash and 59% equity value for the median S&P 500 Director.

(3.) **Director retirement plans and other perquisites have disappeared**. In 1996, the National Association of Corporate Directors (NACD) released its Blue Ribbon Report on Director Professionalism. In that report, the NACD stated that (i) compensation tied to Director tenure, especially Director retirement plans, was inappropriate for compensating Directors and (ii) company programs for non-employee Directors should be composed solely of cash and equity. As a result, most public companies moved to drop their Director pension plans and other retirement plans within the ensuing 3 years. Today, many companies allow their Directors to voluntarily defer their annual equity grants or equity equivalent grants into some form of nonqualified deferred compensation plan. Such compensation is usually deferred until the Director's service on the Board terminates and may be paid in either a lump sum or a series of payments. It should be noted that some companies have recently required a portion of the annual equity grant to be deferred.

(4.) **Directors are subject to stock ownership guidelines**. Institutional investors and their advisory firms deem executive ownership of a meaningful amount of company stock to be an important consideration and in all shareholders' best interests. This same tenet holds true for non-employee Directors. Now, 89% of S&P 500 companies have adopted stock ownership guidelines for corporate Directors. The median stock ownership guideline requires Directors to acquire and hold company shares equal to 5 times the annual cash retainer within the first 5 years of Board service.

(5.) **Supplemental cash retainers are paid to Committee Chairs.** Much of a Board's work is performed at the committee level. Certain committees, especially the Audit and Compensation Committees, follow rigorous schedules to uphold their governance responsibilities in these key areas of corporate respect to their committee service and are usually paid supplemental cash retainers. We found that S&P 500 median Committee Chair retainers were Audit Committee Chair at $20,000, Compensation Committee Chair at $20,000, and Governance Committee Chair at $15,000.

In Summary

Today, Director compensation programs look quite similar from company to company. The primary difference between programs is the level of compensation (typically correlated to company size and/or industry sector), not the form of compensation. Even Director compensation levels for S&P 500 directors are significantly more compressed than they have been historically. The range of director total compensation between the 25th percentile, median and 75th percentile are now 11% and 13% of median, respectively. As corporate governance norms have evolved, the preferred model for compensating Directors has become almost universal.

Is this homogeneity in Director compensation program design going to continue into the foreseeable future? We do not expect drastic change in the form of Director programs for the next several years, although we do anticipate market increases annually in the amounts of Director compensation. The attraction and retention of skilled and qualified Directors is of paramount importance to U.S. companies, their shareholders, and the execution of effective corporate governance principles. The current approach to compensating Directors principally in cash and equity is well aligned with shareholder interests and companies' need to compensate Directors fairly and equitably.

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The Limits of Shareholder Ratification for Discretionary Director Compensation

Posted by Gail Weinstein, Philip Richter, and Adam Kaminsky, Fried, Frank, Harris, Shriver & Jacobson LLP, on Thursday, December 21, 2017

Editor's note: Gail Weinstein is senior counsel, and Philip Richter and Adam Kaminsky are partners at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank publication by Ms. Weinstein, Mr. Richter, Mr. Kaminsky, Steven Epstein, Warren S. de Wied, and Robert C. Schwenkel.

In re Investor Bancorp, Inc. Stockholder Litigation, issued by the Delaware Supreme Court on Dec. 13, 2017, may result in challenges to compensation awarded to directors pursuant to existing discretionary equity plans and is likely to affect the structure of future equity plans.

The Supreme Court, at the motion to dismiss stage, rejected the Court of Chancery's expansion of the application of the stockholder ratification defense to the granting of discretionary compensation to directors pursuant to equity plans that contain "meaningful limits" on awards. Reversing the decision below, the Supreme Court held that deferential business judgment review will *not* be available for (and the entire fairness standard of review will apply instead to) challenges to awards made under such equity plans if the plaintiff alleges facts that support an inference that the directors may have breached their fiduciary duties when determining the awards. The Supreme Court reasoned that when stockholders grant directors broad authority to use their discretion in making self-interested decisions, the stockholders do so knowing that the directors are subject to fiduciary standards in exercising that discretion; and that, therefore, there is a need for judicial oversight of the exercise of that discretion. The Supreme Court found in this case that the alleged facts sufficiently supported an inference of breach by the directors of their fiduciary duties for purposes of a motion to dismiss, as the awards granted appeared to have been "excessive" (based on their having been very significantly higher than the past compensation and the compensation at peer companies).

Pending further judicial development, it is uncertain how broadly the decision will be applied. In our view, notwithstanding the change in judicial course:

- ***With respect to an existing equity plan***, there should not be much risk of liability unless clearly excessive compensation was awarded under the plan (and/or there were other seriously problematic factors such as a flawed process or disclosure).
- ***With respect to future equity plans***, it should be possible to structure a plan to minimize the risk of liability by reducing the amount of (but not necessarily eliminating all) director discretion in determining awards under the plan. (See "Practice Points" below.)

Background

Investor Bancorp (which completed a bank mutual-company-to-stock conversion in 2014) accepted its Compensation Committee's recommendation and set 2015 compensation for its directors and officers at the same levels as in 2014. A few months thereafter, the board proposed a discretionary equity incentive plan (EIP) to provide "additional incentives." The EIP provided "meaningful limits" for awards—that is, a specified number of shares of common stock were reserved for restricted stock awards, restricted stock units, incentive stock options, and non-qualified stock options for the company's officers, employees, non-employee directors, and service providers. Sub-limits were provided for each category of award and each category of recipient. The non-employee directors were entitled to up to 30% of all of the reserved options and restricted stock shares, all of which could be granted in any calendar year. The number, types, and terms of the awards were subject to the board's discretion and would not be determined until after the stockholder approval of the EIP. Over 96% of the voting shares (which represented 79% of the shares outstanding) approved the EIP. Three days after the EIP was approved by the stockholders, the board held the first of four meetings during which, over the course of a month, they determined to issue to directors in 2015 (including the two executive directors, who were the CEO and COO) half of the available stock options and one-third of the available restricted shares, which had a total fair value of $51.7 million.

Discussion

The entire fairness standard of review will apply to challenges of discretionary awards under stockholder-approved equity compensation plans that include "meaningful limits"—if the facts pled indicate a possible breach of fiduciary duties by the directors. Due to directors' inherent self-interest when they determine discretionary equity awards for themselves, challenges to these awards have generally been subject to the entire fairness standard of review. However, when an equity plan approved by the stockholders provides for fixed awards, or when the specific awards made under a discretionary equity plan were ratified by the stockholders, then business judgment review has applied—based on ratification by the stockholders in a context where they "knew what they were approving." The Delaware Supreme Court long ago extended the stockholder ratification concept to discretionary equity plans that are "self-executing"—that is, where the awards are determined based on a formula, without further discretion by the directors.

Over the years, the Court of Chancery has extended the stockholder ratification concept further. While the Court of Chancery established that stockholder-approved discretionary equity plans with "generic" or "overall" limits on awards for directors and employees in the aggregate would *not* be entitled to business judgment review (*Calma/Citrix v. Templeton* (2016)), it has held that stockholder-approved equity plans with "meaningful limits" (*i.e.*, a specified cap applicable to the sub-group of non-employee directors) *would* be entitled to business judgment review (because stockholders approving the plan would know the contours of the awards that will be possible) (*3M Corp.* (1999), *Seinfeld v. Slager* (2012), and *Investor Bancorp* (Apr. 5, 2017)). In *Investor Bancorp*, the Supreme Court has now rejected that approach with respect to equity plans with "meaningful limits." Instead, in the event of a challenge to awards issued under such a plan, if the facts alleged indicate that it is reasonably conceivable that the directors breached their fiduciary duty when exercising their discretion in making the awards, then the directors will have to prove that the awards were entirely fair to the corporation.

The Supreme Court found that the alleged facts in this case as to the "excessive" nature of the awards sufficiently supported an inference (at the motion to dismiss stage) of a breach of fiduciary duties by the directors. The Court of Chancery had ruled that, although the awards were large in relation to the company's past compensation and peer group, they were within the equity plan's specified sub-limits and the plaintiffs had not established that they were so exorbitant as to constitute waste. The Supreme Court held, however, that the facts alleged indicated a possible breach of fiduciary duties, based on the awards having been "significantly" higher than the directors' past compensation and "inordinately" higher than directors' compensation at peer companies.

The Supreme Court's rationale for the change in course was a "need for continued equitable review of self-interested discretionary director self-compensation decisions." Justice Seitz wrote:

> When stockholders approve the general parameters of an equity compensation plan and allow directors to exercise their broad legal authority under the plan, they do so precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty. The stockholders have granted the directors the legal authority to make awards. But, the directors' exercise of that authority must be done consistent with their fiduciary duties. Given that the actual awards are self-interested decisions not approved by the stockholders, if the directors acted inequitably when making the awards, their 'inequitable action does not become permissible simply because it is legally possible' under the general authority granted by the stockholders…. [Stockholder approval of an equity incentive plan] cannot be reasonably interpreted as a license [for the directors] to do whatever they [wish], unconstrained by equity. Rather, it is best understood as a decision by the stockholders to give the directors broad legal authority and to rely upon the policing of equity to ensure that that authority would be utilized properly.

In our view, directors are unlikely to have liability for awards issued under discretionary plans unless the awards were excessive and/or there are other significantly problematic factors (such as a flawed process or disclosure). Pending further judicial development, in our view, liability is not likely unless there is a highly negative factual context, as was alleged in this case, where:

- The average compensation paid to the Investor Bancorp non-employee directors in 2014 was $133,340—which was in line with the average at peer companies; whereas the average paid in 2015 (including under the EIP) was over $2 million—while the average at peer companies was less than $176,000.
- The CEO's total compensation package was seven times higher than in 2014, and the $16.7 million value of the stock options and restricted stock he was awarded under the EIP was alleged to be 1,759% higher than the peer companies' average compensation for executive directors (and 3,683% higher than the median award that peer companies granted their CEOs after mutual-to-stock conversions).
- The COO's total compensation package was nine times higher than in 2014, and his $13.4 million award under the EIP was alleged to be 2,571% higher than the peer companies' average compensation for executive directors (and 5,384% higher than the

median that peer companies paid to their second-highest paid executives after conversions).

- The plaintiffs alleged that the disclosure relating to the approval of the EIP was flawed. The stockholders were told that "by approving the [EIP], stockholders will give the Company the flexibility it needs to attract, motivate and retain highly qualified officers, employees and directors by offering a competitive compensation plan that is linked to the performance of the Company's stock." The plaintiffs alleged that this statement was "forward-looking"—that is, that stockholders would have understood that awards under the EIP would incentivize *future performance*, not reward past services. After stockholders approved the EIP, however, the board approved the award of about half of the stock options and one-third of the restricted shares available to the directors, vesting over five years—which, the plaintiffs alleged, rewarded *past efforts* in connection with the company's mutual-to-stock conversion.
- The plaintiffs also alleged that the directors' process for determining the awards was flawed. For example, according to the plaintiffs, the expert who had advised the Compensation Committee had not considered an appropriate list of companies when determining peer company averages; and the CEO allegedly had proposed the awards for himself and the COO and they had attended the meetings at which their awards were approved although the company had disclosed that they had not attended meetings at which their compensation was determined.

Practice Points

- **With respect to future director compensation plans**, there is a clear safe harbor in (a) having stockholders approve the specific equity awards or (b) adopting a "self-executing" equity plan. Alternatively, a company could consider whether there is a place on the continuum between "self-executing" equity plans and equity plans with "meaningful limits" where the court, under *Investor Bancorp*, would view the directors as having had sufficiently little discretion, and the stockholders as having had sufficient knowledge as to what they were approving, that business judgment review would apply. For example, the following could be considered:
    - An equity plan that provides that the awards are essentially "self-executing," by being determined based on a formula without further discretion by the directors other than potentially providing plan administrators (generally the board or a committee of directors) with the ability to use negative discretion under certain circumstances;
    - An equity plan that provides specific limits for each individual director rather than for directors in the aggregate—as the stockholders would, in effect, be approving for each director a specific award, up to the maximum set for that director;
    - An equity plan that provides more restrictive "meaningful limits" (such as not only sub-limits for each group but limits for each year) and/or provides very specific guidelines for setting awards (such as the award having to be within a specified range of peer companies' average compensation and/or other quantitative parameters)—so that the degree of director discretion involved is minimized and stockholders are provided with more specificity as to what they are being asked to approve; or,
    - An equity plan that combines a specific award piece, a self-executing piece, and a discretionary piece, with the discretionary piece subject to specific caps or

other mechanisms that limit the discretion (such as, detailed parameters or, possibly, determination of the discretionary piece by an independent consultant or a designated director who will not receive discretionary awards).

- **With respect to existing discretionary director compensation equity plans,** boards should take particular care when approving the grant of equity awards—from the perspective both of substance (*i.e.* , the amounts of the awards) and process, with the objective of minimizing the risk of excessive compensation claims. A board may also consider amending its existing discretionary director compensation equity plans (a) to make them "self-executing" or (b) to conform to one of the formulations described below. A board may wish to seek stockholder ratification of awards already made if a favorable outcome would be expected.
- **Importance of the process, the disclosure and the record.** When determining awards under an equity plan, the directors should establish a record that documents what principles they applied to determine the awards, as well as how the awards compare to past compensation and peer companies' compensation and the business rationale for any differences. The disclosure relating to the approval of an equity plan should be accurate (including whether the awards will reward past performance or incentivize future performance) and consistent with the purpose and material provisions of the equity plan. We note that, based on the facts alleged, the process and disclosure in *Investor Bancorp* suggested possible duplicity on the directors' part in terms of the timing of the setting of the awards (immediately after stockholder approval of the equity plan), and not disclosing to stockholders that the awards would relate to the directors' efforts in connection with the mutual-to-stock conversion that had just been completed and would be very large.

Tab IV: Investor Stewardship, Communication and Rights

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Investor Stewardship Group: An Inflection Point in U.S. Corporate Governance?

Posted by John C. Wilcox, Morrow Sodali, on Thursday, March 30, 2017

Editor's note: John C. Wilcox is Chairman of Morrow Sodali. This post is based on a Morrow Sodali publication by Mr. Wilcox. Additional posts on the Investor Stewardship Code are available here.

A potentially influential new organization of institutional investors has made its presence known in the U.S. corporate governance scene. On January 31, 2017, the Investor Stewardship Group (ISG), a "collective" of some of the largest U.S. and international investors, announced the launch of an ambitious program to establish a set of basic corporate governance principles for U.S. listed companies and a parallel set of stewardship principles for U.S. institutional investors (discussed on the Forum here). This unprecedented event could be a turning point in the evolution of U.S. governance practice.

Here are some of the reasons why the ISG and its principles could have a significant impact on U.S. companies:

1. The formation of the ISG is noteworthy not just because of the group's size, global reach and financial clout ($17 trillion in assets under management). W hat is unusual is that ISG's members are the individuals within financial institutions who manage their day-to-day governance responsibilities—setting policies, engaging with portfolio companies and voting proxies. The ISG opens a door to this important but sometimes hard-to-reach audience of decision-makers whose policies companies need to understand and with whom companies should try to establish a relationship of trust through constructive dialogue and engagement. These are the individuals companies want to reach when they conduct governance road shows.

2. The ISG introduces into the U.S. a framework for the type of principles-based corporate governance that is the norm in virtually all countries outside the U.S. It is a voluntary system that relies on a "comply-or-explain" accountability mechanism rather than the rules-based, strict-compliance, liability-based governance system found in the U.S. Voluntary, principles-based governance should be welcomed by U.S. issuers because it encourages a flexible, case-by-case approach in which business strategy and financial goals are given priority over compliance with external governance standards. As the governance spotlight focuses more deeply on boardroom transparency and implementation of ESG policies rather than just a check list of best practices, the advantages of principles-based, comply-or-explain governance will become increasingly apparent to U.S. companies and investors alike.

3. The simultaneous launch of governance principles and stewardship principles conveys an implicit message that companies and institutional investors share responsibility for the economic success of portfolio companies. The idea that providers of capital and managers of business enterprises should work together for a common economic goal may seem like common- sense capitalism, but it is often forgotten in the adversarial, fight-first-ask-questions-later attitude that at times has colored relations between companies and shareholders. This is the case particularly in the U.S., where the legal system establishes formal structures for confrontation—in particular, SEC Rule 14a-8 governing shareholder proposals—and is seen as presenting obstacles to dialogue or disclosure outside regulatory guidelines.

4. The ISG initiative is focused exclusively on U.S. companies and investors. This can be taken as a sign that ISG members, all of which have portfolios of both U.S. and global stocks and are familiar with global governance practices, believe that the U.S. is where their attention is most needed. The ISG governance proposal does have roots in the U.S.—the need for a uniform U.S. governance code has been discussed intermittently for more than a decade, but consensus has not been reached largely because of two obstacles: corporate governance is deemed to be outside the remit of the SEC and a single national code seemed impractical in light of 50 separate state corporate law statutes. As ISG members clearly understand, national codes play a central role in the governance systems of countries outside the U.S. By introducing a national code of principles applicable to all U.S. listed companies, the ISG's goal, in the words of Anne Sheehan, Director of Corporate Governance at CalSTRS, "is to codify the *fundamentals* of good corporate governance and establish *baseline expectations* for U.S. corporations and their institutional shareholders." By contrast, the ISG's stewardship initiative is rooted in global practice. National stewardship codes have been adopted in the UK, Canada, Italy, Japan, Malaysia, the Netherlands, South Africa, Switzerland and Taiwan and endorsed by the International Corporate Governance Network. The European Commission's recent amendments to the Shareholders' Rights Directive also strengthen provisions relating to engagement and stewardship. It is noteworthy that "stewardship," rather than "fiduciary," is the concept promoted by the ISG, suggesting a focus on oversight of portfolio companies in the broadest sense, including ESG and non-financial factors rather than simply financial performance and legal compliance.

5. The ISG's six governance and six engagement principles are brief, clear and succinct, drafted in general terms that allow room for flexibility in their interpretation and application. They contain no surprises, are within established guidelines, are not overly prescriptive and do not expand shareholder rights or create new obligations for either companies or institutional investors. They are designed to function as guiding principles rather than a list of do's and don'ts. The principles "reflect the common corporate governance beliefs that are embedded in each member's proxy voting and engagement guidelines" and they avoid conflict with existing legal structures and regulatory requirements. They also reflect commonplace governance standards that have already been adopted by many companies in the U.S. and abroad. The ISG framework can therefore be seen as posing no additional compliance burdens on either companies or investors.

6. ISG's condensed governance principles offer a counterpoint to proxy advisory firms' more detailed governance standards and voting guidelines based on proprietary models. Although the ISG's stated intention is not to replace or reduce the importance of proxy advisory firms, its principles-based approach reflects the continuing evolution of governance away from external standards and compliance check lists. Fundamental principles of the type proposed by the ISG are easier to apply contextually, allowing more room for substantive dialogue between companies and investors and encouraging a case-by-case approach that integrates business strategy and ESG decision-making.

7. Because the ISG governance and stewardship principles will not take effect until January 2018, the year of lead time will enable the ISG, which describes itself as a “sustained initiative,” to recruit additional members, increase its public profile and answer a number of important questions that will determine its effectiveness over the long term: the group’s leadership and governance; its plans for enforcing its principles; its relationship with existing governance organizations and NGOs; and, most important, the relationship of ISG’s members to the leadership and investment arms of their own institutions. A number of ISG member firms’ CEOs are signatories to the Commonsense Principles of Corporate Governance, published in July 2016. Are these activities coordinated or expected to achieve a common goal?

The ISG’s promulgation of a governance code and stewardship principles for the United States represents a private sector initiative that has the potential to fundamentally change the relationship between U.S. companies and institutional investors and to align U.S. corporate governance more closely with global practice. The next year will tell whether this potential will be realized. In the meantime, companies and investors alike should pay attention to developments at the Investor Stewardship Group.

Appendix

ISG Corporate Governance Principles

- Principle 1: Boards are accountable to shareholders.
- Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest.
- Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
- Principle 4: Boards should have a strong, independent leadership structure.
- Principle 5: Boards should adopt structures and practices that enhance their effectiveness.
- Principle 6: Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

ISG Stewardship Principles

- Principle A: Institutional investors are accountable to those whose money they invest.
- Principle B: Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.
- Principle C: Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.
- Principle D: Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.
- Principle E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.

- Principle F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles.

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Corporate Governance and Financial Regulation
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Common-Sense Capitalism

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Friday, July 27, 2017

Editor's note: David A. Katz is a partner and Laura A. McIntosh is a consulting attorney at Wachtell, Lipton, Rosen & Katz. The following post is based on an article by Mr. Katz and Ms. McIntosh that first appeared in the *New York Law Journal.*

Recent developments in corporate governance indicate a welcome emphasis on common sense principles. Over the past year, leaders of prominent companies and institutional investment funds have proposed principles and a framework intended to guide U.S. corporate governance toward practices that promote the sustainable creation of long-term value. The shared goal of these two separate projects—the Investor Stewardship Group's "Corporate Stewardship and Governance Principles," released in 2017 (discussed on the Forum here), and "Commonsense Principles of Corporate Governance," an open letter released in 2016 (discussed on the Forum here)—is to bolster companies' ability to generate prosperity for American investors. Prioritizing practicality over prescription should improve the quality and effectiveness of corporate governance, to the benefit of all market participants.

Stewardship and Governance Principles

The Investor Stewardship Group—a collective of U.S.-based institutional investors and global asset managers—launched an initiative in January 2017 to establish a framework for standards of stewardship and corporate governance to promote long-term value creation in American business. The ISG represents $17 trillion in assets under management and is led by the participating firms' senior corporate governance practitioners. The framework, set to become effective in January 2018, contains six principles for investor stewardship and six principles for corporate governance. While the framework has no legal force, it is modeled on the "comply or explain" governance frameworks that exist in the United Kingdom and elsewhere and is intended to stand as an unofficial national code of fundamental governance principles. The framework is not intended to be prescriptive and is expected to be revised periodically as consensus around stewardship and governance evolves. Since it lacks any enforcement or self-policing mechanism, the principles will only become meaningful through widespread adoption by market participants.

The stewardship principles highlight two positive trends in corporate governance. The first is that business leaders are uniting to promote cooperation and improve communication among companies, large investors, and shareholders. The second is that institutional shareholders may be reclaiming much of the authority they ceded to proxy advisory firms in recent decades. One of the stewardship principles is that institutional investors are responsible for proxy voting decisions and should monitor the activities and policies of proxy advisors, and another is that institutional investors should address and resolve differences with companies in a constructive and pragmatic manner. These principles are designed to increase accountability, improve communication, and create a sense of shared responsibility between investors and companies. If successful, they will go a long way toward reducing the heretofore outsized influence of proxy advisors in the corporate governance sphere. Pending legislation in Congress that would regulate proxy advisory firms may accelerate this development. Without undue pressure from proxy advisors to conform to one-size-fits-all governance practices, and with the support of their institutional investors, companies should benefit from greater flexibility to implement the practices that are most effective in their particular circumstances.

The corporate governance principles set forth by the ISG cover topics such as director independence and leadership and board responsiveness to shareholders. They also address board accountability, shareholder voting rights, and management incentive structures and are elaborated with fairly detailed guidance on each point. While the principles do advocate some policy positions, such as proportional voting and proxy access, these specifics are less important than the overarching themes of accountability, transparency, and effectiveness. Under this framework, a company with a compelling record of furthering the key governance principles, albeit through different governance practices, should find support among its investors.

The 2016 open letter, "Commonsense Principles of Corporate Governance" is a separate effort, operating at a higher level of generality than the ISG principles. The letter was signed by ten well-known corporate leaders in a range of industries, including the chief executives of General Motors, JPMorgan Chase, Berkshire Hathaway, GE, and Blackrock. The signatories emphasized that public companies hold a public trust, and that the financial future of American families depends on the success of America's business sector and public confidence in America's financial markets. While acknowledging a diversity of opinion on corporate governance matters, the letter proposed a baseline for constructive dialogue on matters of governance. The recommendations in the letter hewed to a number of well-established principles: director independence and leadership, board diversity, financial accounting transparency, and constructive shareholder engagement. The letter also encouraged companies to provide quarterly earnings forecasts only when beneficial to shareholders and not as a matter of obligation. While not a dynamic project like the ISG framework, the letter has the potential to be significant, as it indicates that American business leaders today are focused on promoting rationally-based, prosperity-oriented corporate governance. With continued engagement between institutional investors and public companies, there is an opportunity to foster lasting change in the corporate governance paradigm.

Looking Ahead

As corporate law is a matter of state, rather than federal, law, corporate governance generally is not within the purview of the Securities and Exchange Commission. The diversity of state corporate law is a valuable feature of the U.S. business landscape. While many countries have uniform governance codes, corporate governance in the United States is a patchwork of state law, stock exchange rules, federal requirements, and prevailing norms. Nonetheless, the SEC can be a factor in encouraging the current trend toward common sense governance, a project which would seem to align with the agenda of SEC Chairman Jay Clayton. Chairman Clayton indicated this month, in his first official speech, that his tenure will prioritize "the long-term interests of the Main Street investor." The SEC is undertaking initiatives to improve the quality and utility of disclosures provided to investors through simplification, modernization, and an emphasis on readability. Chairman Clayton also intends to empower individual investors through education and information resources. As disclosures become more legible, and as shareholders become better informed, the quality of communication between companies and investors should improve significantly, producing more meaningful dialogue, more responsive boards, greater credibility between investors and management teams, and better governance overall.

In recent decades, there has been at times a counterproductively antagonistic relationship between institutional investors and corporations. Efforts such as the ISG framework may help to shift this dynamic into a constructive and cooperative one. Companies and their long-term investors should be united in their shared goals of prosperity and good governance, and both should seek governance norms that help to produce sustainable growth and success. The framework established by the ISG potentially represents a new phase in corporate governance. Inspired by the common-sense guidance of business and regulatory leaders, corporate governance is poised to move into its next phase: one in which ethical principles and good business values are implemented across the marketplace as context-driven accountability and shared economic success.

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Engagement—Succeeding in the New Paradigm for Corporate Governance

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday, January 23, 2018

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton publication by Mr. Lipton, Steven A. Rosenblum, Karessa L. Cain, and Sabastian V. Niles.

The accelerated interest in sustainability, ESG, corporate social responsibility and investment for long-term growth and value creation (the new paradigm) as most cogently exemplified by Value Act's newly formed Spring Fund focusing on promoting environmental and social goals of the companies in which it invests; by the promotion by the World Economic Forum of *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*; by the creation of the Investors' Stewardship Group and its issuance of its principles for stewardship which embrace ESG and long-term investment; and, finally, by the policy positons of the three largest index fund managers, BlackRock, State Street and Vanguard as to what they expect in the way of governance and engagement, especially the January 12, 2018 letter from Larry Fink, BlackRock's CEO, to the CEOs of the companies in which BlackRock invests in which "corporate purpose" is stressed, prompts us to update our January 2017 memo on engagement with investors.

The BlackRock letter states:

> Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Then, most importantly, the letter sets out the type of engagement between corporations and their shareholders that BlackRock expects in order to secure its support against activist pressure. While the whole letter needs to be carefully considered in developing investor relations engagement practices, the following is of special note,

> In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth. I want to reiterate our request, outlined in past letters, that you publicly articulate your company's strategic

> framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors. This demonstrates to investors that your board is engaged with the strategic direction of the company. When we meet with directors, we also expect them to describe the board process for overseeing your strategy.
>
> The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to climate change—affect your potential for growth.

While the BlackRock letter is a major step in rejecting activism and short- termism and is a practical guide as to investor relations, it stops short of a critical step in assuring corporations that their efforts are bearing fruit—it does not commit BlackRock to publicly state its support for a corporation under attack by an activist seeking to impose financial engineering or other short-term action before the corporation has to endure a proxy fight. This type of early concrete support would be a major factor in supporting sustainability and long-term investment. That being said, it does not in any way diminish the importance of understanding and appropriately reacting to the letter and the views of BlackRock and other investors.

In designing its engagement program and practices, each company should make its own independent decision as to content, persons, venues and intensity of its communications and what adjustments, if any, to its strategy and operations may be appropriate to meet the expectations of investors who have embraced the new paradigm.

What to Communicate

Lead with the Purpose and the Strategy. In the new paradigm, the company's purpose and long-term strategy, its implementation and the company's progress in achieving it take center stage. Check-the-box governance fades into the background. Define the company and its vision, explain key drivers of strategy and business outcomes and articulate how a portfolio of businesses and assets fit together and are reviewed. Discuss key risks and mitigation methods and share how the company evaluates whether the strategy remains viable as the business environment, competitive landscape and regulatory dynamic change. Discuss how a business model has transformed, and if the company is in the midst of a strategic transformation or a well-conceived turnaround plan that requires time to execute, explain it. The BlackRock letter advises:

> Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?

Confirm Board Involvement in the Strategy. The company should explicitly describe how the board has actively reviewed long-term plans and that it is committed to doing so regularly.

Proactively share with these investors how directors are integrated into strategic planning, exercise robust oversight and test and challenge both strategy and implementation. In the new paradigm, be clear and direct about the board's role in guiding, debating and overseeing strategic choices.

Make the Case for Long-Term Investments, Reinvesting in the Business for Growth and Pursuing R&D and Innovation. The company should clearly explain how such investments are reviewed and articulate why and how they matter to long-term growth and value creation. For investments that will take time to bear fruit, acknowledge that and explain their importance, timing and progress.

Describe Capital Allocation Priorities. This also includes discussing the board's process for reviewing and approving capital allocation policies. Where return of capital is a pillar of the company's value creation framework, demonstrate thoughtfulness about the timing, pacing and quantum of buybacks and/or dividends and an awareness of relative tradeoffs. If maintaining an investment-grade or fortress balance sheet is a priority, clarify why.

Explain Why the Right Mix of Directors Is in the Boardroom. Present the diverse skills, expertise and attributes of the board as a whole and of individual members and link those to the company's needs and risks. Be transparent about director recruitment processes that address future company and board needs. Disclose the policy for ensuring that board composition and practices evolve with the needs of the company, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. Carefully explain procedures for increasing the diversity of the board and for ensuring that directors possess the skills required to direct the course of the company. Discuss director orientation, tutorials and retreats for in-depth review of key issues. Show that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

Address Sustainability, Citizenship and ESG/CSR. The company should integrate relevant sustainability and ESG matters into strategic and operational planning and communicate these subjects effectively. Sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm.

Articulate the Link Between Compensation Design and Corporate Strategy and Risk Management. Describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.

Discuss How Board Practices and Board Culture Support Independent Oversight. Clearly articulate the actual practices and responsibilities of the lead independent director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing themselves to ensure priorities are met.

How to Deal With an Activist. A paragraph in the BlackRock letter sums it up well:

> Where activists do offer valuable ideas—which is more often than some detractors suggest—we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

How to Communicate

Periodic "Letters" to Investors. Periodic "letters" to shareholders on behalf of the management and/or board focusing on the issues deemed important for satisfaction of the new paradigm are valuable. Letters from management can articulate management's vision and plans for the future, explain what the company is trying to achieve and discuss how it plans to win in the market. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead independent director or non-executive chair, come from particular committees as to matters within their ambit or be from the full board.

Investor Days. The company should use "Investor Days" to articulate a long-term perspective on company prospects and opportunities and provide "deep dives" into strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined. Deciding which long-term metrics, goals and targets should be shared is an area in active evolution. All of the company's major long-term investors, including "passive" investors and index funds, should be extended an invitation. Key materials from a completed Investor Day can also be separately circulated to investors. The company may also invite directors to attend. In certain cases, it may be useful for a director to participate in an Investor Day to validate and communicate board involvement and priorities.

Quarterly Communications. Quarterly earnings rituals remain, for now, a fact of life in the U.S. Nevertheless, the company can place quarterly results in the context of long-term strategy and objectives, discuss progress towards larger goals and articulate higher priorities, all while eschewing quarterly guidance.

Proxy Statements, Annual Reports, Other Filings and the Company's Online Presence. Proxy statements, annual reports/10-Ks, SEC filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled "The Board's Role in Risk Oversight" will ultimately evolve into section(s) covering "Board Oversight of Strategy and Risk." The company should present information online in readily accessible, user- friendly and well-organized formats.

Investor Engagement. Disciplined, direct and periodic two-way dialogue with institutional investors is advisable, supported by written communications and tailored presentations. Opening channels of communication in advance of a crisis or activist challenge is extremely important. Communicate engagement procedures and activity. Prepare for director-level interactions with major shareholders and know when and how to involve directors—proactively or upon appropriate request—without encroaching upon management effectiveness. Do not hesitate to reach out to investors, even during proxy season, if there is a matter of importance to discuss. Coordinate internal outreach across the different categories of shareholders and have a superstar corporate governance executive and a superstar investor relations executive. A number of the major investors are increasing substantially their stewardship teams that meet with investors.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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What Do Investors Ask Managers Privately?

Posted by Eugene F. Soltes and Jihwon Park (Harvard Business School), on Monday, January 15, 2018

Editor's note: Eugene Soltes is the Jakurski Family Associate Professor of Business Administration and Jihwon Park is a doctoral candidate at the Harvard Business School. This post is based on their recent paper.

Investors and managers of publicly traded firms spend a considerable amount of time speaking privately. According to the consultancy Ipreo, the average publicly traded firm conducts more than 100 one-on-one meetings annually with investors. While growing body of research provides evidence that these offline interactions offer investors in attendance opportunities to make more informed trading decisions. what actually goes on during these interactions has largely been elusive to outsiders.

In this paper, we seek to better understand the content of private manager-investor interactions by exploring over 1,200 questions posed by investors during private meetings with firm managers from two publicly traded firms. We acquired access to this unique field data by embedding a confederate with extensive investor relations experience in two firms from 2015 to 2016.

Working with investor relations officers (IROs), we devised a classification system for the questions posed by investors and found that they can be categorized into five distinct groups. The first type seeks more detailed insight and clarity of information that is already publicly available. For example, for the biotechnology firm in our sample, one investor asked if the final product would be manufactured in the same facility as the product used in regulatory trials. Other types include questions inquiring about management philosophy (e.g. "What keeps you up at night?"), questions seeking public information more efficiently (e.g. "Can you tell me about the level of share ownership by senior management?"), and questions seeking managers' feedback on proprietary ideas and investment theses (e.g. "What looks more attractive right now: M&A activity or share buybacks?").

Finally, the fifth type of questions are those seeking more timely information from managers. These are questions where the investor seeks data or information that is more recent than that available from public sources. For instance, one question that we observe investors frequently asking is around *current* cash holdings. Notably, the investor is not seeking the figure publicly disclosed in the 10-Q a month prior to the meeting. Rather, they are seeking to acquire an update of the financial statement information as of the date of the meeting.

We examine whether the types of questions asked by investors are predictable based on the personal background of the investor, their shareholdings in the firm, the characteristics of the fund they work for, and the venue where the offline interaction took place. Broadly, we find that in numerous instances the type and frequency of questions are strongly associated with several of these characteristics. In particular, investors who are more experienced and meet with managers of the firm more often are more likely to ask timely questions. Moreover, investors who hold a position in the firm, work for larger funds, and meet more often are less likely to ask efficiency questions that are readily answered by referring to public data sources.

We have data on the venues of meetings (i.e. conference, roadshow, or private phone call) and find that investors who gain access to management during a roadshow or private call ask the most questions. However, the greater number of questions asked during roadshows tends to be driven by the fact that the duration of the interactions is longer on average for roadshows. When the duration of the interaction is taken into account, conference meetings and private calls tend to be the most efficient meetings in terms of the number of questions asked. Management philosophy questions (e.g. "What keeps you up at night?") potentially convey direct informational benefits, but also offer insight into managers via their body language and expression. We find that investors tend to less frequently ask such philosophical questions during private calls as compared to physical in-person interactions.

We also examine the differences in the types of questions asked publicly (during conference calls) to those asked privately during offline meetings. We find that the vast majority of questions on public conference calls are questions seeking greater detail, and we find no examples of timely or efficiency questions being asked. We also find that the number of dialogues is similar between public and private meetings, but the lack of superfluous pleasantries tend to mean that there is more interaction in private settings.

Prior research on private meetings has examined whether offline interactions are associated with changes in trading of the firm's security. We further expand this analysis by examining whether such trading around private meetings is predominately associated with certain kinds of meetings based on the types of questions asked by investors. We find that aggregate trading in a firm's security is higher when more forward looking questions are asked. Moreover, we find that when investors ask more forward looking or negative questions during private interactions, they are more likely to increase or decrease their position in the firm over the quarter. While this analysis is subject to a number of caveats associated with our ability to measures changes in ownership surrounding meetings, this preliminary evidence suggests certain kinds of interactions between managers and investors are more likely to generate the kinds of "benefits" associated with private meetings that has been documented in the prior literature.

Overall, our analysis begins to illuminate the confidential interactions between managers and investors. The fact that our sample firms would allow us to record these interactions suggests that they believed they conservatively approached these interactions with investors. Nonetheless, the nature of some of the questions—in particular those related to acquiring more timely information—and managers' potential willingness to respond shows the difficulty in easily classifying what is viewed as permitted under Reg FD.

The complete paper is available here.

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A Practical Guide to Virtual-Only Shareholder Meetings

Posted by Steven M. Haas and Charles L. Brewer, Hunton & Williams LLP , on Friday, November 17, 2017

Editor's note: Steven M. Haas is a partner and Charles L. Brewer is an associate at Hunton & Williams LLP. This post is based on a Hunton & Williams publication by Mr. Haas and Mr. Brewer. This post is part of the Delaware law series; links to other posts in the series are available here.

Last year, a record number of public companies held virtual-only shareholder meetings, which are now permitted in Delaware, Virginia, and numerous other states. Despite some shareholder opposition, we believe this trend is likely to continue. This post provides a comprehensive overview of practical issues that a company must consider in deciding whether to switch to, and then how to implement, virtual-only shareholder meetings.

Whether to Hold a Virtual-Only Shareholder Meeting

Proponents of virtual-only shareholder meetings argue that they are more efficient and convenient for both corporations and shareholders, may result in higher levels of attendance by shareholders, and permit an equivalent level of engagement between shareholders and corporations' directors and officers as in-person meetings. Virtual-only meeting advocates also note that uncontested shareholder meetings are poorly attended and almost always perfunctory rather than substantive. Moreover, they argue that most corporations provide substantive performance updates to their investors through quarterly earnings calls, not annual shareholder meetings. In short, advocates believe that the time and costs of conducting an in-person meeting outweigh the benefits.

Critics of virtual-only shareholder meetings believe that nothing can replace the opportunity for shareholders to sit in the same room as a corporation's directors and officers and "look them in the eye." Critics also believe that corporations may use virtual-only meetings to "cherry pick" favorable questions at the expense of pointed or negative questions. These criticisms have led to unfavorable press for some companies holding virtual-only meetings. In addition, critics note that corporations interested in virtual-only meetings could instead hold hybrid meetings, which would result in many of the benefits of virtual-only meetings while avoiding the drawbacks.

Corporations will need to consider how their shareholder base may react to a virtual-only meeting. Because of the potential for investor backlash, corporations may want to engage privately with key institutional shareholders to gauge their reaction to a virtual-only meeting. Some shareholders—including the New York City Comptroller—have indicated they will vote against directors whose corporations held virtual-only meetings in the prior year. The Council of Institutional Investors has stated that corporations "should hold shareowner meetings by remote communication (so-called 'virtual' meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute." Moreover, some companies have received shareholder proposals calling for them to hold only in-person shareholder meetings. Thus, the decision to hold a virtual-only meeting could have serious consequences in the form of negative media attention and votes "against" directors. On the other hand, it seems that some institutional shareholders do not view virtual-only meetings as a significant issue, at least in uncontested elections.

Because so many companies held virtual-only shareholder meetings in 2017, we believe 2018 could be a pivotal year for the future of virtual-only meetings since we will see how many investors register their displeasure by voting against directors who authorized virtual-only meetings. For that reason, many companies considering virtual-only meetings may defer their decision to 2019 in order to see how investors react this year.

As set forth in a report by the Best Practices Working Group for Online Shareholder Participation in Annual Meetings (the "*Best Practices Working Group*"), there is no one correct approach to holding shareholder meetings. We believe that corporations will need to determine on a case-by-case basis whether in-person, hybrid or virtual-only meetings are most appropriate under the circumstances.

Preliminary Considerations for Holding a Virtual-Only Shareholder Meeting

Statutory Requirements

Not all states permit corporations to hold virtual-only shareholder meetings. In states that do permit virtual-only meetings, corporations will need to review the applicable statutory requirements carefully before attempting to replace an in-person shareholder meeting with a virtual-only meeting. This post focuses on Virginia and Delaware, but note that other states may have materially different or additional requirements for virtual-only meetings that this post does not address.

The statutory requirements for holding shareholder meetings in Virginia and Delaware are substantially the same. In both states, corporations holding a virtual-only meeting must take reasonable measures to (i) verify that each shareholder participating remotely is in fact a shareholder or a shareholder's proxy and (ii) give each shareholder a reasonable opportunity to participate in the meeting and vote on matters submitted to the shareholders, including an opportunity to read or hear the proceedings of the meeting substantially concurrently with the proceedings.

Organizational Documents and Board Authorization

In addition to reviewing the applicable statutory requirements, corporations must confirm that their certificates or articles of incorporation and bylaws permit virtual-only shareholder meetings. Many bylaws may require a physical location and would therefore need to be amended to allow for a virtual-only meeting. For example, a corporation's bylaws might be amended to provide that meetings shall be held "at such place *or no place, solely by means of remote communication*, as may be fixed by the Board of Directors."

Furthermore, both Virginia and Delaware require that boards "authorize" remote participation by a corporation's shareholders. Thus, the board should adopt a resolution authorizing remote participation in the meeting. A board-adopted bylaw that expressly authorizes virtual meetings may satisfy this requirement, but having the board adopt a specific authorizing resolution for each virtual-only meeting is usually prudent.

Federal Securities Laws and Stock Exchange Rules

Other than with respect to proxy solicitations and shareholder proposals made under Rule 14a-8 of the Securities Exchange Act of 1934 (discussed below), federal securities laws generally do not address how corporations should conduct shareholder meetings. Furthermore, the Securities and Exchange Commission has allowed at least two corporations to exclude from their proxy materials a shareholder proposal that the corporation hold in-person rather than virtual-only annual meetings. In each case, the corporation was permitted to exclude the proposal under Rule 14a-8(i)(7) as relating to the corporation's ordinary business operations.

Both the New York Stock Exchange and Nasdaq require listed companies to hold annual meetings, but they generally do not prescribe how annual meetings must be conducted. Nasdaq, however, does require that shareholders "must be afforded the opportunity to discuss Company affairs with management" at each annual meeting. Depending on how the virtual meeting is to be conducted, a Nasdaq-listed corporation may want to contact Nasdaq to discuss compliance with this rule.

Proxy Contests and Other Contentious Votes

Shareholder meetings that involve a proxy contest or other contentious vote likely will be held in person rather than virtually. The greater complexity, need for discussion at the meeting, larger number of votes likely to be cast during the meeting, and increased chance that an adjournment could be necessary all weigh heavily in favor of holding an in-person meeting if the corporation expects a close or contested vote. Moreover, while many institutional investors may not object to a virtual-only format for a routine annual meeting, they could be quite opposed to this decision in a contested election, given the criticisms noted above. For these and other reasons, some providers of virtual meeting platforms will not host contested shareholder meetings.

Conducting a Virtual-Only Shareholder Meeting

After confirming that the laws of its state of incorporation and its organizational documents permit virtual-only shareholder meetings, a corporation interested in holding a virtual-only meeting must consider how to comply with the applicable statutory requirements. For essentially all public corporations, this will mean engaging an outside service provider. Because corporations must provide the ability for shareholders to vote securely, it is likely impractical, if not impossible, for most public corporations to hold a virtual-only meeting without third-party assistance. An experienced service provider like Broadridge or Computershare can provide a robust and usually cost effective platform to host a virtual-only meeting more easily than a corporation could develop the technology and related expertise necessary to host a virtual-only shareholder meeting on its own. For privately-held companies, whether a third-party service provider is necessary will depend on the circumstances.

Meeting Format: Audio-Only or Video

The most fundamental decision a corporation must make regarding a virtual-only shareholder meeting is whether it will be audio-only or include video. An audio-only meeting is substantially similar to an earnings call, with the key addition of shareholder authentication and voting through a secure website.

Speakers are heard but not seen, although the corporation can supplement the audio-only meeting with a contemporaneous slide presentation. A meeting that includes video will involve a live video feed of the corporation's participants. The proceedings will generally resemble an in-person shareholder meeting, with the obvious exception that no shareholders would be in physical attendance.

Corporations holding virtual-only meetings have overwhelmingly chosen audio-only meetings. Holding an audio-only meeting is cheaper and technologically easier than also broadcasting live video. A live video feed requires, among other things, cameras and a larger production team. An audio-only meeting may also reduce the chance that the media would widely report any disruption of the meeting, since video can be more interesting and reportable than audio alone. On the other hand, broadcasting live video, which would allow shareholders to observe the corporation's representatives as they answer shareholder questions, could help assuage critics' fears that virtual-only meetings are intended to insulate a corporation's directors and officers from its shareholders. Thus, a live video feed could result in less criticism that a corporation is "hiding" from shareholders by holding a virtual-only meeting.

Voting

Corporations must be able to verify that each remote participant is a shareholder or a proxyholder. As discussed above, most public corporations that hold virtual-only shareholder meetings delegate this process to a third-party service provider. Shareholder verification typically occurs by including a unique code in each shareholder's proxy materials that he or she can use to log in to the meeting website. If a shareholder casts a vote during the meeting, his or her unique code allows the proxy solicitor to ensure that the shareholder's proxy, if one was submitted, is replaced by the shareholder's vote cast during the meeting.

Safeguarding Against Technological Problems

Before holding a virtual-only shareholder meeting, each company will want to do a "dry run" of the meeting with its virtual meeting platform provider. The company should also have contingency plans to deal with a technological failure, such as a power or network outage. These contingency plans should include scenarios in which there is a brief outage where the meeting can be promptly reconvened, and a prolonged outage that requires the meeting to be reconvened on a later day. As discussed below, the corporation should also have a contingency plan in case a technological failure interferes with the ability of a shareholder to present his or her proposal.

To minimize the risk of a technological failure disrupting the meeting, corporations should structure the agenda of any virtual meeting to bring matters to a vote, close the polls, and adjourn the formal part of the meeting as quickly as possible. With the formal part of the meeting done, the corporation can then turn

Shareholder Questions

Although not as fundamental to shareholder meetings as voting, question and answer sessions give most shareholders their only opportunity to engage directly with a corporation's directors and officers. At traditional, in-person shareholder meetings, corporations generally allow shareholders to pose questions directly to the directors and officers. The appropriate directors or officers then respond immediately to the questions asked. Some shareholders believe that this "live" format is the best way to ensure a candid (i.e., unscripted) response to shareholder questions. Along similar lines, the Best Practices Working Group noted that corporations should ensure that they are not "using technology to avoid opportunities for dialogue that would otherwise be available at an in-person shareholder meeting."

For virtual-only shareholder meetings, corporations have a number of options regarding how shareholder questions can be presented, including:

- **Live Questions via Telephone.** Corporations can structure the meeting similarly to an earnings call, with an operator managing a queue of shareholders who will ask questions via telephone using a dial-in number. This is the most similar to in-person meetings, and we expect that many shareholders—particularly activist retail shareholders—would prefer this option.
- **Live Questions via Text.** Virtual meeting platforms offered by third-party service providers allow shareholders to submit questions in text during the meeting. These questions typically are not seen by other shareholders. Compared to the telephone option, shareholders may view this as less effective for presenting potentially negative questions. It also gives the corporation some discretion in choosing which questions to answer.
- **Pre-Submitted Questions.** Corporations may require that shareholders submit all questions in advance, either through pre-recorded audio or video files or in writing. This option gives the corporation the most discretion regarding which questions to answer. In addition, some critics argue that it results in less candid answers because the corporation will prepare a scripted response in advance of the meeting. Corporations that require pre-submitted questions believe that a prepared response—which can be more substantive and complete than unprepared remarks—is more useful to shareholders without any loss of candor.

Unless a corporation chooses to permit live questions via telephone, it will usually need to engage in some editorial control over the questions its directors and officers answer. At a minimum, the corporation (and shareholders) would want to eliminate duplicate questions and questions that are off-topic or inappropriate. But some shareholders believe that corporations will "cherry pick" favorable questions and downplay, rephrase, or ignore questions that are seen as overly negative or hostile. Corporations can take steps to alleviate this concern by providing transparency into how they select shareholder questions, including by committing to respond to all reasonable questions at the meeting or, if too many questions are received, to post all questions on a website available to shareholders and respond to them after the meeting.

To date, virtual-only shareholder meetings have not resulted in a marked increase in the number of shareholder questions as compared to in-person meetings. Because many more shareholders can attend virtual-only meetings than in-person meetings, however, this trend may change in the future. Furthermore, live questions via text and pre-submitted questions offer anonymity to shareholders that could result in more aggressive or confrontational shareholder questions.

Shareholder Proposals

Under Rule 14a-8 of the Securities Exchange Act of 1934, shareholders who have owned at least $2,000 in market value, or 1 percent, of a corporation's securities "entitled to be voted on the proposal at the meeting" for at least one year may submit proposals for inclusion in a corporation's proxy statement.

Rule 14a-8 requires that either the proponent or his or her qualified representative present the proposal at the shareholder meeting. If permitted by the corporation, proponents may appear through electronic media rather than in person.

Corporations that intend to hold a virtual-only shareholder meeting, therefore, must determine how shareholder proposals will be presented. Options include:

- providing a dedicated dial-in number for the shareholder or the shareholder's designated representative to speak (similar to an earnings call);
- permitting proponents to provide an audio or video recording of their presentation, which the corporation would play during the meeting; or
- designating a representative of the corporation to read the proposal or an introduction to the proposal submitted in advance by the proponent.

Among virtual meetings held in 2016, Broadridge reported that most corporations preferred to provide a separate dial-in number for proponents. The corporation should also have a backup plan to present the shareholder proposal on the proponent's behalf if the proponent has a technical issue that prevents him or her from presenting the proposal personally. For example, the proponent can provide the corporation with a copy of his or her remarks that can be read by the corporation's representative in the event the dedicated dial-in number does not work.

Pre-Meeting Communication

As explained above, many decisions need to be made in advance of a virtual-only shareholder meeting with regard to voting, shareholder questions, and shareholder proposals. Corporations will reach different decisions on these issues in light of their particular shareholder base and their historical practices for holding shareholder meetings. Regardless of the result of any particular decision, however, corporations should publish their procedures for shareholder participation in virtual-only meetings just as they would for in-person meetings. Corporations should adhere to those procedures to ensure that all shareholders receive—and feel that they have received—a meaningful opportunity to participate in the shareholder meeting even though it occurred virtually rather than in-person. Thoughtful, specific procedures may help forestall any complaints shareholders have regarding a virtual-only meeting taking the place of an in-person meeting.

Recap of Key Issues

As explained above, there are numerous issues that need to be considered before holding a virtual-only meeting, including:

- whether to engage with institutional shareholders before deciding to hold a virtual-only meeting;
- whether holding a virtual-only meeting will result in significant “withhold” votes or votes “against” the directors;
- whether to permit non-shareholder attendees, such as analysts, employees, or the media, to view the meeting;
- how to structure the agenda of the meeting in order to conclude the formal business as soon as possible;
- what contingency plans to prepare to address a technological failure, including contingency plans for a short network outage, a prolonged network outage, and the inability of a shareholder proponent to present his or her proposal, as well as state law issues regarding whether notice of the reconvened meeting must be given;
- whether a recording or transcript of the meeting will be available after the meeting and, if so, for how long;
- how shareholders will present shareholder proposals, such as through a designated dial-in number or a pre-recorded audio or video statement;
- how shareholders can ask questions, including in advance, by text, or “live,” and if “live,” how to deal with disruptive or otherwise inappropriate behavior;
- how to decide which shareholder questions will be answered, including how to deal with duplicate or inappropriate questions, how to respond to questions submitted by text or in advance if there is not enough time to answer them during the meeting, and the level of transparency to provide to explain how questions will be chosen;
- how to maintain the required record of any vote or action taken by remote communication;
- how to ensure the inspector of elections is familiar with virtual meeting voting procedures and has access to the voting portal to confirm proper opening and closing of the polls; and
- what information to include in the corporation’s proxy materials regarding its switch to a virtual-only shareholder meeting, and whether to publicize shareholders’ ability to attend the meeting virtually in other locations (e.g., on the corporation’s website).

Conclusion

We hope it is clear from the foregoing discussion that making the switch from an in-person to a virtual-only shareholder meeting can be a lengthy process, with many issues that must be considered and decided well in advance of the meeting date. Experienced legal counsel and third-party service providers can help corporations analyze the issues, but each corporation considering whether to hold a virtual-only meeting will need to take into account its historic practices with respect to shareholder meetings, its shareholders’ previous level of engagement, and whether it expects shareholders to protest its adoption of virtual-only meetings.

In addition, as virtual-only meetings become more popular, particular practices may coalesce regarding how to address the issues described in this post. Corporations and their advisors will need to continue monitoring the best practices in corporate governance and adjust their meeting procedures accordingly.

* * *

The complete publication, including footnotes, is available here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

Virtual-Only Shareholder Meetings: Streamlining Costs or Cutting Shareholders Out?

Posted by Robert Richardson, Glass, Lewis & Co., on Tuesday, November 28, 2017

Editor's note: Robert Richardson is manager of North American Proxy Research at Glass, Lewis & Co. This post is based on a Glass Lewis publication by Mr. Richardson.

In a fast-paced technological world, where efficiency and streamlining are often viewed as key drivers of success, it's no surprise that companies have started to livestream their shareholder meetings and to allow investors to participate remotely. Adding an online component can broaden the franchise, giving shareholders the chance to attend the "hybrid" physical/online meeting even if they can't travel to it.

However, more and more companies are going a step further—not just adding an option for online participation, but removing the in-person alternative. The 2017 U.S. proxy season saw 163 companies hold virtual-only shareholder meetings, an increase from 122 virtual-only meetings held during the 2016 U.S. proxy season.

Virtual-only meetings are held exclusively online with no in-person participation or physical location. They have been met with skepticism and resistance alike from investors, as well as the Council of Institutional Investors (CII). In a press release announcing its intention to engage with investee companies over the issue, the NYC Comptroller expressed concerns that some companies "are likely using online-only meetings to insulate themselves from uncomfortable interactions with concerned shareholders," and announced its intention to vote against directors at companies that hold virtual-only meetings. CII took a more diplomatic tone in a letter to Broadridge, acknowledging potential benefits but maintaining that "[i]nvestors expect virtual meeting technology to enhance the ease of attendance and the quality of the meeting without harming its integrity…."

So, why are companies increasingly moving towards virtual-only?

The advantages of such meetings are clear from an issuer perspective. Hosting virtual-only meetings can cut out some of the standard costs of holding annual in-person shareholder meetings, as online meetings are typically less expensive and time-consuming. Renting function rooms and catering costs are among some of the expense factors that would be eliminated. And as the NYC Comptroller suggests, it also gives the company more control over the proceedings, potentially reducing the chances that the board or management will be embarrassed by a tough shareholder query.

And that's where investor concerns come in. While an online meeting may increase the number of attendees, it can also serve to reduce those attendees' level of participation. For example, a trend in virtual-only meetings is for shareholders to submit their questions to the company prior to convening the meeting. There is a fear that this allows the company the discretion to filter shareholder questions to its own taste, resulting in some of the more difficult or controversial questions getting bumped down the priority list or even ignored. Even if fair play were guaranteed, for the less tech-savvy shareholder, removing the opportunity to voice concerns in a public, in-person, forum, where that individual is more at ease, could be construed by some as an infringement on shareholder rights.

So far, those looking to push back against the trend have been largely stymied. The 2016 proxy season saw several virtual-only companies receive shareholder proposals seeking the return of a traditional, physical meeting format. These proposals were granted “no-action” requests from the SEC, citing a company’s right to govern the format of annual meetings. With virtual-only meetings apparently not going away, the discussion may be shifting towards finding a virtual-only format that protects the quality of the meeting. For example, CII’s aforementioned letter to Broadridge set out a range of features that should be offered to virtual meeting attendees, including a transparent system for monitoring submitted questions, and the opportunity to virtually “approach the dais” and speak to company representatives following the meeting.

As more and more companies move towards virtual-only meetings, the debate on how (and whether) they should be conducted looks set to continue. In the meantime, absent an accepted best practice format, investors may get less access to the board, management, and other shareholders at virtual-only meetings—making pre-meeting preparation, including engagement with issuers and between investors, all the more important.

Excerpt

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Tax Reform Implications for U.S. Businesses and Foreign Investments

Posted by Philip Wagman, Richard Catalano, and Alan Kravitz, Clifford Chance, on Friday, January 5, 2018

Editor's note: Philip Wagman and Richard Catalano are partners and Alan Kravitz is an associate at Clifford Chance. This post is based on a Clifford Chance publication by Mr. Wagman, Mr. Catalano, and Mr. Kravitz.

On December 20, 2017, Congress voted to enact the most sweeping US tax reform bill in decades. The Tax Cuts and Jobs Act (the "TCJA" or the "Act") will reduce business tax rates and revamp the US international tax system. While the President may not sign the Act until January 2018, its adoption into law appears virtually certain.

Overview

The TCJA's proponents in Congress intend it to boost US businesses by making a host of changes to how they are taxed. While the legislation has (somewhat unexpectedly) passed through Congress at warp speed, many of its basic ideas have been advanced in some form by the Act's Republican authors for over a decade. Key provisions of the Act include, as described in more detail below, a permanent reduction in the US federal corporate income tax rate from 35% to 21%; reduced tax rates (ranging up to 29.6%) for many US businesses organized as partnerships, limited liability companies (LLCs) and S corporations; immediate expensing of the full cost of equipment bought before 2023; and broad changes to the United States' international tax rules, including tax-free repatriation of profits earned abroad in the future.

The TCJA may well spur US M&A activity, by raising after-tax rates of return on investment in US companies. However, the new law's impact on even routine corporate transactions can vary dramatically—for better or for worse—depending on precisely how those transactions are structured. The Act also has a disparate impact on differently situated businesses. In effect, the Act's authors give:

- three cheers for US companies with significant US operations, who benefit from rate reductions and accelerated expensing;
- two cheers for US multinationals, who get a territorial system (subject to some key limits) and who also will now repatriate hundreds of billions of dollars of earnings accumulated offshore, at reduced tax rates up to 15.5%; and
- one cheer for non-US multinationals with material US operations, who face new anti-avoidance rules aimed at limiting historically accepted means of repatriating profits from the United States without material US tax costs.

[continued]

Two Cheers For US Companies Investing Abroad

Prior to the Act, the United States' tax laws did not give a US parent company of a multinational group the benefit of a "territorial system," under which profits of non-US subsidiaries earned overseas would be exempted from US tax when those profits were repatriated back to the United States. Instead, contrary to the approach adopted by other major world economies, the United States taxed such profits at regular US corporate rates when they were repatriated back to the US parent, with a credit for any taxes paid overseas on those profits by the corporate group. The Act seeks to switch to a territorial system; but it contains limits designed to ensure that most or all of a US-headed multinational group's income is taxed at least once, somewhere in the world.

- *Exemption for Dividends from Non-US Affiliates*. Under the Act, a US corporation is generally entitled to deduct the full amount any dividend paid to it by a non-US company at least 10% of whose shares are owned by the US corporation. The effect of the deduction is that such dividends are exempt from US corporate income tax.
    - *Exemption applies to JVs*: As noted, this benefit is available not only for dividends from a US corporation's wholly-owned or majority-owned non-US subsidiaries, but also for dividends from any non-US JV in which the US corporation has (at least a 10%) minority interest.
    - *Limits on exemption*: The exemption is available only to a US corporation that holds its interest in the non-US company for over a year. Dividends received during the first year of a US corporation's holding period are eligible for the exemption, as long as the US corporation ends up holding the shares of the non-US company for over a year. In addition, the exemption is generally not available for a dividend paid on a hybrid instrument (treated as equity for US tax purposes, but treated as debt, or as some other instrument that generates deductible payments for the non-US company, for non-US tax purposes).
    - *Gain on sales of shares*: The Act does not provide a specific exemption for a US corporation's gain from a sale of shares in a 10%-owned non-US company. But, it often may be possible for a US corporation to get the effect of a partial or full exemption.
        - Under the US tax laws, a US corporation generally must re-characterize a portion of its gain from a sale of shares of a 10%-owned non-US company as a dividend, if over 50% of the shares of that non-US company are owned by large US shareholders (each with a stake of 10%

or more). In such a case, the portion of the seller's gain treated as a dividend equals the seller's pro rata share of any retained earnings of the non-US company whose shares are being sold. Thus, for example, if a US parent sells shares of a non-US subsidiary that has significant retained earnings, then a large part of the US parent's gain on the sale would be re-characterized as a dividend—and, as a result, would be exempt from US tax, under the new rules.

        - If a non-US company sells a business in an asset sale (or a transaction structured to be treated as an asset sale for US tax purposes), and the non-US company then distributes the sale proceeds to its US parent, then the US parent generally would get an exemption from US tax for all of the sale proceeds it receives. (This US tax advantage would need to be balanced, however, against any increase in non-US tax costs that might arise as a result of structuring the transaction in this manner.)

- *Mandatory Repatriation*. Without a forced repatriation rule, Congress' adoption of a territorial system would allow non-US subsidiaries to pay dividends to their US parent corporations, out of (hundreds of billions of dollars of) earnings built up offshore before 2018, and fully escape US tax on those earnings. Congress instead opted to impose a one-time US tax on those earnings, at rates far lower than a US parent would have paid before the Act.
    - Under the Act, a 10% (or greater) US shareholder must include in its income, in 2017, its share of a non-US company's earnings that have not previously been subject to US tax. This rule applies to all 10% US shareholders (including US individuals and US pass-through entities), even though only a 10% US corporate shareholder will benefit from the new territorial system.
    - To the extent a non-US corporation has invested its accumulated earnings in cash or cash equivalents, a 10% US shareholder will be taxed at a 15.5% rate on those earnings. A 10% U.S. shareholder will be taxed at an 8% rate on earnings that have been reinvested in the corporation's business (such as in non-U.S. property, plants and equipment).
    - Although a 10% US shareholder's tax liability will be triggered when it includes the offshore earnings in its income in 2017, the US shareholder is entitled to elect to pay off this tax liability in installments over eight years, as follows: 8% in each of the first five years after 2017 (2018—2022); 15% in the sixth year (2023); 20% in the seventh year (2024); and 25% in the eighth year (2025).
- *Low-Taxed Intangibles Income*. Under the Act, a US parent corporation generally will have to pay an immediate US income tax (at a 10.5% rate, increasing to 13.1% after 2025) on a big part of the profits of its non-US subsidiaries, in the year those profits are earned regardless of whether or when the profits are repatriated to the United States, unless the non-US subsidiaries (in the aggregate) pay a material amount of non-US income taxes on their profits.
    - This special regime applies to "global intangible low-taxed income" (GILTI) earned by a US parent's non-US subsidiaries. Broadly, GILTI is defined as the non-US subsidiaries' earnings, reduced by a formulaic amount representing the part of those earnings attributable to the non-US subsidiaries' tangible depreciable assets (e.g., machinery and equipment).
    - From 2018 through 2025, the US parent must pay US income tax on its pro rata share of the non-US subsidiaries' GILTI at a 10.5% rate. In 2026 and thereafter, the rate rises to 13.1%.

- A US parent is entitled to a credit against this US income tax, for 80% of the total amount of non-US income taxes that it and its subsidiaries pay on their GILTI. The practical effect is that, from 2018 through 2025, a US parent will pay no US income tax on its GILTI, provided the effective rate of non-US tax imposed on such income is at least 13.1%. (10.5% = 80% x 13.1%.) If the non-U.S. effective tax rate is less than 13.1%, then the US parent's corporate group will pay a combination of US and non-US income taxes on the group's GILTI, at combined effective rates ranging from 10.5% to 13.1%. (Similarly, in 2026 and thereafter, the US parent will pay no US tax on its GILTI, provided the effective rate of non-US tax on the GILTI is 16.4%. Otherwise, the US parent's corporate group will pay a combination of US and non-US income taxes on the group's GILTI, at combined effective rates ranging from 13.1% to 16.4%.)
- The GILTI rules apply not only where a US corporation is the parent of non-US subsidiaries, but also where a US pass-through entity is the parent (or where a US individual owns a non-US company). However, the impact of the rules on a pass-through entity and US individuals owning it (or on an individual that directly owns a non-US company) often will be more severe, than in the case of a US corporate parent. This is in part because such US individuals normally will not be entitled to the 80% tax credit described above.

- *Export Incentive*. The TCJA provides a rate benefit for a US corporation's income derived from serving non-US markets. The benefit applies to "foreign derived intangibles income" (FDII), which is broadly defined as all of a US corporation's income generated from property sold, leased or licensed by a US corporation to any person that is not a US person, reduced by a formulaic return on the tangible assets used in generating such income. A US corporation will be taxed at a 13.1% rate on its FDII, in 2018 through 2025; thereafter, the rate increases to 16.4%. This provision, together with the GILTI rules, seemingly is meant to incentivize US multinationals to locate in the United States more of their assets and operations that are used in serving overseas markets. However, it is unclear how strong this incentive will prove to be: sales to overseas customers made by a non-US subsidiary of a US parent generally are subject to US tax under GILTI at a 10.5% rate (13.1% after 2025)—i.e., 2.6 percentage points lower than the rate imposed on the US parent's FDII. Also, it has yet to be determined whether the FDII rules comply with international trade agreements.

On balance, the new territorial system makes it attractive for a US company to buy or invest in non-US subsidiaries and JVs. However, acquisition and investment opportunities where profits will be subject to low or no non-US income taxes may turn out to be more costly than anticipated, absent structuring to address the new "GILTI" rules.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

The SEC and Mandatory Shareholder Arbitration

Posted by Cydney Posner, Cooley LLP, on Thursday, February 22, 2018

Editor's note: Cydney S. Posner is special counsel at Cooley LLP. This post is based on a Cooley publication by Ms. Posner.

Depending on your point of view, you may have experienced either heart palpitations or increased serotonin levels when you heard, back in July 2017, that SEC Commissioner Michael Piwowar had, in a speech before the Heritage Foundation, advised that the SEC was open to the idea of allowing companies contemplating IPOs to include mandatory shareholder arbitration provisions in corporate charters. As reported, Piwowar "encouraged" companies undertaking IPOs to "come to us to ask for relief to put in mandatory arbitration into their charters." (See our earlier post on the Forum.) As discussed in this PubCo post, at the same time, in Senate testimony, SEC Chair Jay Clayton, asked by Senator Sherrod Brown about Piwowar's comments, responded that, while he recognized the importance of the ability of shareholders to go to court, he would *not "prejudge" the issue.* According to some commentators at the time, to the extent that these views appeared to indicate a significant shift in SEC policy on mandatory arbitration, they could portend "the beginning of the end of securities fraud class actions." Then, in January of this year, the rumors about mandatory arbitration resurfaced in a Bloomberg article, which cited "three people familiar with the matter" for the proposition that the SEC is "laying the groundwork" for this "possible policy shift." But in recent Senate testimony, Clayton reportedly put the kibosh on these signals.

As discussed here, the concept of mandatory arbitration of shareholder claims has been run up the flagpole a few times in the past. The idea took hold in the late 1980s, when SCOTUS concluded that stock brokers could enforce mandatory arbitration agreements with customers. However, in subsequent encounters, the SEC has not been particularly receptive to the idea. When a private equity fund sought to go public in 2012 with a provision in its partnership agreement requiring mandatory individual arbitration of any disputes, including disputes under the federal securities laws, Corp Fin advised that it would not accelerate effectiveness of its registration statement, and the provision was withdrawn. Then, in an interesting turn of events, binding shareholder proposals were submitted at several companies seeking to amend their bylaws to *include* mandatory shareholder arbitration provisions. (If this seems a bit curious, the argument submitted by the proponent was that the costs of frivolous class action litigation were ultimately borne by the shareholders, and preventing these suits would therefore benefit shareholders.) Some of these companies, attempting to *exclude* the proposals from their proxy statements, contended that they should be excludable under Rule 14-8(i)(2)—on the basis that implementation would cause the company to violate applicable law—because implementation would violate Section 29(a) of the Exchange Act. Section 29(a) declares void any provision "binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder…." Since the bylaw prohibited claims subject to arbitration from being brought in a representative capacity, that is, in class actions, the company argued, the provision effectively waived shareholders' abilities to bring claims under Rule 10b-5. The SEC allowed exclusion of the shareholder proposal, agreeing that there was some basis for the view that implementation of the proposed bylaw amendment would cause the company to violate the federal securities laws.

The impetus for the recent reemergence of the concept of mandatory arbitration in the context of IPOs seems to be the continued hand-wringing over the dearth of IPOs. Commissioner Michael Piwowar has previously observed that, "since 2000, the average annual number of IPOs is 135—less than one-third the average annual number of IPOs—457—in the 1990s…. In the 1980s and 1990s, IPOs with proceeds of less than $30 million constituted approximately 60 percent and 30 percent, respectively, of all IPOs. In fact, some of the most iconic and innovative U.S. companies…entered the public market as small IPOs. This trend reversed in the 2000s. IPOs with proceeds less than $30 million accounted for only 10 percent of all IPOs in the period 2000-2015. By comparison, large IPOs have increased from 13 percent in the 1990s to approximately 45 percent of all IPOs since then."

SideBar

Not everyone agrees that the fretting over the decline in IPOs is appropriate. According to EY, what happened—largely the result of acquisitions and delistings—happened primarily by 2002; it's not just a recent phenomenon. And much of the decline may reflect the popping of the dot-com bubble in the first years of the new millennium. Accordingly, some would argue that a number of those companies should not have gone public in the first place and that measuring against the height of the bubble is wrong-headed. (For more discussion regarding the decline in IPOs and public companies, see this PubCo post, this PubCo postand this PubCo post.)

More recently, a Treasury report, A Financial System That Creates Economic Opportunities—Capital Markets, issued in October last year, asserted that concerns about becoming the target of securities class actions may discourage companies from going public. To make matters worse, the report observed, the number of class actions has recently increased from 151 in 2012 to 272 in 2016, with 317 filed in the first nine months of 2017 (although still below the peak of 498 actions in 2001). The level of class actions was particularly striking in light of the decline in the number of public companies. However, most cases settled; according to the report, only "21 cases since the adoption of the Private Securities Litigation Reform Act of 1995 have gone to trial." The report also observed that some commentators view class actions as useful tools for accountability and deterrence of wrongdoing. At the end of the day, however, the report did not advocate mandatory arbitration; instead, it recommended that both the states and the SEC "investigate the various means to reduce costs of securities litigation for issuers in a way that protects investors' rights and interests, including allowing companies and shareholders to settle disputes through arbitration." (See this PubCo post.)

But according to an article in Pensions & Investments, in testimony regarding ICOs before the Senate Banking Committee on Tuesday, February 6, Clayton indicated that barring shareholder securities fraud litigation was not in the offing. In questioning, Senator Elizabeth Warren, referring to the news report cited above that the SEC was considering allowing companies to adopt mandatory arbitration provisions, asked whether Clayton would support this "enormous change." According to the article, "Mr. Clayton said that while he could not dictate whether the issue comes before the Securities and Exchange Commission, he is 'not anxious to see a change in this area.'" In addition, he observed, "'If this issue were to come up before the agency, it would take a long time for it to be decided, because it would be the subject of a great deal of debate. In terms of where we can do better, *this is not an area that is on my list of where we could do better,*' Mr. Clayton told the committee." [Emphasis added.]

Reviving the U.S. IPO Market

Posted by Michael S. Piwowar, U.S. Securities and Exchange Commission, on Tuesday, May 16, 2017

Editor's note: Michael S. Piwowar is a Commissioner at the U.S. Securities and Exchange Commission. This post is based on Mr. Piwowar's recent Opening Remarks at the SEC-NYU Dialogue on Securities Market Regulation. The views expressed in this post are those of Mr. Piwowar and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Good morning, and thank you, Dean Henry, for that kind introduction. It is a pleasure to be here. Thanks also to Alexander Ljungqvist and others from the Salomon Center for the Study of Financial Institutions at New York University, as well as the staff in the Securities and Exchange Commission's ("SEC") Division of Economic and Risk Analysis, for organizing today's [May 10, 2017] Dialogue.

I am happy to join you in this discussion and exchange of ideas on the current state of, and outlook for, the U.S. initial public offering ("IPO") market. This event is particularly timely, because it coincides with the arrival of Jay Clayton, the SEC's new Chairman as of last week. He has made it clear that, under his leadership, making public capital markets more attractive to business while providing appropriate safeguards for investors will be a priority for the Commission.

An IPO has historically been one of the most meaningful steps in the lifecycle of a company. Going public gives a growing company access to an important source of funding—the public equity market—allowing it to raise capital from a diverse group of investors, often at a lower cost compared to other funding sources. This capital can be used to hire employees, develop new products and technologies, and expand operations. The beneficial uses to which that capital may be put are even more pronounced for small companies because they tend to be more innovative than large companies and they account for a substantial percentage of the jobs created every year.

Furthermore, IPOs give successful entrepreneurs an exit strategy for some or all of their investment, and provide an opportunity for them to allocate their capital and talent to other productive ventures. The same is true for institutional and other early-stage investors. IPOs also have important implications for employees for whom a portion of compensation before the IPO is a promise of future payment from options and stock grants. Through an IPO, such employees can access secondary market trading of the firm's securities and therefore translate anticipated compensation to real dollars.

A vibrant IPO market also allows retail investors to add economic exposure from growing firms and industries to their investment portfolios, either directly or through vehicles such as mutual funds. As such, investors can share in the wealth created by these companies and enhance their overall risk diversification.

Notably, IPOs can enhance capital formation in both public and private markets. For example, if private sources of capital are aware that companies have a viable financing alternative through public markets, an entrepreneur may be in a better position to realize more favorable financing terms from more sources. The number of value-enhancing projects and innovations thus may increase.

In addition, an active IPO market can enhance efficient decision-making among suppliers of capital. The robust disclosures generated by newly public firms provide investors information to better evaluate investment options because they serve as benchmarks versus other companies both public and private. When complemented with the information provided to the market by third parties such as securities analysts, disclosures by IPO firms provide an important layer of investor protection that typically is not available in private markets.

Given all of the benefits I just articulated, the importance of IPOs to the U.S. economy cannot be overstated. In a nutshell, a robust IPO market encourages entrepreneurship, facilitates growth, creates jobs, and fosters innovation, while providing attractive opportunities for investors to increase their wealth and mitigate risk.

For decades, the United States enjoyed a strong IPO market that produced a steady supply of newly public firms and allowed millions of investors to participate in the value creation generated by those firms. Many foreign companies chose to go public in the United States, which gave U.S. investors global investment options to diversify portfolios. For those foreign companies, an IPO in the United States enabled them to expand their funding sources and take advantage of a lower cost of capital compared to their domestic markets. In fact, between 30 percent and 50 percent of worldwide IPOs occurred in the United States during the 1990s.[1]

In the last 15 years, however, the reduction in IPO activity has been dramatic. For example, since 2000, the average annual number of IPOs is 135—less than one-third the average annual number of IPOs—457—in the 1990s.[2] This decline has occurred despite the fact that there has been no downward trend in the creation of new companies over the same period. Traditional economic factors, such as fluctuations in companies' demand for capital and changes in investor sentiment, also cannot explain the large decrease. Strikingly, the fraction of worldwide IPOs occurring on U.S. markets fell below 10 percent between 2007 and 2011.[3]

The substantial drop in the number of IPOs in the United States is primarily driven by the disappearance of small IPOs. In the 1980s and 1990s, IPOs with proceeds of less than $30 million constituted approximately 60 percent and 30 percent, respectively, of all IPOs.[4] In fact, some of the most iconic and innovative U.S. companies, such as Apple, Cisco, and Genentech, entered the public market as small IPOs. This trend reversed in the 2000s.[5] IPOs with proceeds

[1] *See* Craig Doidge, G. Andrew Karolyi, and Rene M. Stulz, "The U.S. left behind? Financial globalization and the rise of IPOs outside the U.S.," *Journal of Financial Economics* (Dec. 2013).

[2] *See* Michelle Lowry, Roni Michaely, and Ekaterina Volkova, "Initial Public Offerings: A Synthesis of the Literature and Directions for Future Research" (Mar. 20, 2017), *available at*https://ssrn.com/abstract=2912354 .

[3] *See* Doidge, et al., *supra* note 2.

[4] *See* Lowry, et al., *supra* note 3.

[5] *Id*.

less than $30 million accounted for only 10 percent of all IPOs in the period 2000-2015. By comparison, large IPOs have increased from 13 percent in the 1990s to approximately 45 percent of all IPOs since then.[6]

What caused this precipitous decline in IPOs, particularly those of small firms, after 2000? Today's event is intended to identify and discuss the potential causes and consequences. I suspect panelists will highlight a variety of factors that have contributed to making it more difficult, or less attractive, for small companies to go public. For instance, the availability of alternative sources of capital, such as from private equity, hedge funds, and even mutual funds, means that private firms may be able to finance growth without having to go public. The emergence of trading venues that provide liquidity for privately-held shares has had the same effect.

In the interest of time, let me quickly list several other possibilities. New offering methods—namely Crowdfunding and Regulation A—have provided alternatives to the IPO. Consolidation in investment banking and brokerage services has left fewer underwriters for small IPOs. Changes in the economic environment due to globalization, along with the "winner-takes-all" trend in some industries, means that firms have to get bigger faster to improve profitability, and therefore may prefer being acquired by a large company instead of growing organically. Macroeconomic factors, such as cheaper debt financing and increased mergers and acquisitions activity, may also play a role.

Moreover, regulatory changes may have contributed to the downward trend in IPOs. The Sarbanes-Oxley Act of 2002 imposed higher regulatory burdens on smaller public companies. Decimalization and Regulation NMS changed the economics of market making for small company stocks and left fewer market makers willing to organize a market for small stocks post-IPO. Modifications to the Section 12(g) shareholder threshold introduced by the Jumpstart Our Business Startups ("JOBS") Act in 2012 also make it more likely that companies will stay private for a longer period of time.

What, then, can be done to revitalize the IPO market, particularly for smaller companies? As a start, during my tenure as Acting Chairman the Commission adopted amendments to conform our rules and forms to Title I of the JOBS Act.[7] Specifically, Title I of the JOBS Act provided an IPO on-ramp for emerging growth companies, allowing them to use scaled disclosure for a certain period of time. It also improved the information available for IPO firms by allowing analyst reports to be published during the quiet period.

I hope that today's Dialogue will generate even more interesting insights and ideas. I look forward to hearing your discussions, analyses, and recommendations. Both Chairman Clayton and I are especially interested in any suggestions for regulatory and other reforms that could be implemented to reverse the more than decade long decline in U.S. IPOs.

Thank you all for agreeing to spend your time with us so that we can benefit from your perspectives. I wish you a day full of enjoyable and fruitful discussions.

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[6] Large IPOs are IPOs with proceeds of more than $120 million. Dollar values are inflation-adjusted.

[7] Securities Act Rel. No. 10332 (Mar. 31, 2017), *available at* https://www.sec.gov/rules/final/2017/33-10332.pdf.

Harvard Law School Forum on
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Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders

Posted by Rick A. Fleming, U.S. Securities and Exchange Commission, on Tuesday, February 27, 2018

Editor's note: Rick A. Fleming is an Investor Advocate with the U.S. Securities and Exchange Commission. This post is based on Mr. Fleming's recent remarks at the *Practising Law Institute*. The views expressed in this post are those of Mr. Fleming and do not necessarily reflect those of the Securities and Exchange Commission or its staff.

Today [February 24, 2018] is a special day for the Office of the Investor Advocate. I started this job four years ago today, and because I am the first Investor Advocate that is also the day the Office of the Investor Advocate came into existence. During the past four years, through the efforts of the talented and dedicated individuals who have joined my Office and work so hard to advocate for investors, we have helped to elevate the Commission's thinking about the needs of today's investors. And we continue to make progress in some important areas. For example, the SEC Ombudsman, Tracey McNeil, has recently launched an electronic Ombudsman Matter Management System (OMMS) to make it easier for investors to let us know of any concerns about the SEC or a self-regulatory organization. An electronic OMMS form is available at the Ombudsman's website, www.sec.gov/ombudsman, and we encourage investors to check it out.

This morning, I would like to share some of my views on the issue of mandatory arbitration and, more specifically, on efforts to force public company shareholders to forego class action lawsuits and seek recovery individually through arbitration. This has been a matter of concern to investors recently,[1] after commentators have suggested that U.S. IPO issuers should consider including arbitration provisions in their articles or bylaws.[2]

The idea of forced arbitration has been promoted as a way to reduce costs of securities litigation for public companies and thereby remove a perceived disincentive for companies to be public. Reportedly, it is too easy for plaintiffs' firms to bring dubious cases and win settlements,[3] and some have argued that class action lawsuits, even meritorious ones, fail to compensate harmed investors in any meaningful way.[4]

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[1] *See* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to William H. Hinman, Dir., Div. of Corp. Fin., SEC (Jan. 29, 2018), http://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2029%202018%20letter%20to%20Mr_%20Hinman%20on%20forced%20arbitration%20(final).pdf.

[2] *See, e.g.,* Stephen Bainbridge, *The SEC Should Authorize Mandatory Arbitration of Shareholder Class Action Lawsuits*, (Jan. 30, 2018, 2:21 PM), http://www.professorbainbridge.com/professorbainbridgecom/2018/01/the-sec-should-authorize-mandatory-arbitration-of-shareholder-class-action-lawsuits.html.

[3] *See* Sara Randazzo, *Companies Face Record Number of Shareholder Lawsuits*, Wall St. J., (Aug. 22, 2017, 5:30 AM), https://www.wsj.com/articles/why-lawsuits-targeting-stock-drops-are-on-the-rise-1503307800.

[4] *See* Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harv. J. L. & Pub. Pol'y 1187, 1194 (2013).

There may be some validity to these concerns. But stripping away the right of shareholders to bring a class action lawsuit seems to me draconian and, with respect to promoting capital formation, counterproductive. Let me explain why.

If we take a step back and look at the big picture, there are some very good reasons why shareholders have been given private causes of action. In the United States, the government has traditionally played a limited role in policing our markets, as evidenced by the fact that only 4,600 SEC employees oversee approximately $72 trillion in securities trading each year, as well as the disclosures of more than 8,100 public companies and the activities of more than 26,000 registered entities.[5] Because of the limited scope of the SEC's resources, investors themselves have typically borne a large share of the responsibility for policing the markets and rooting out misconduct. Over the years, Congress,[6] the Supreme Court,[7] and former SEC Commissioners[8] have recognized the importance of private suits in helping to protect investors and deter wrongdoing.

The SEC, itself, continually reminds investors of its constraints in advocating for their individual interests. Consider how many times every day an investor is told by the SEC staff that we cannot give them legal advice or represent their individual interests. For good reasons, nearly every SEC Investor Alert and hotline phone call includes a disclaimer to the effect that the reader or caller should consult with an attorney who specializes in securities law.[9] In fact, I have personally communicated this to investors many times over the course of my career. When I was a state regulator, I frequently cautioned investors that they should retain private counsel, because even though the interests of victims were generally aligned with the interests of the State of Kansas, those interests could diverge—for example, it might be in the best interest of the state to take away a license, which may decrease the likelihood that a victim would be repaid.

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[5] *Examining the SEC's Agenda, Operations, and Budget: Hearing Before the H. Committee on Financial Services*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20171004.pdf.

[6] Notably, Congress affirmed the importance of preserving the federal securities class action when enacting the Private Securities Litigation Reform Act of 1995, legislation which purported to weed out frivolous suits through a variety of procedural and other measures. Joint Explanatory Statement of the Committee of Conference on H.R. 1058 at 31, *reprinted in* 2 U.S.C.A.A.N. 730 (104th Cong., 1st Sess. 1995) ("The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.").

[7] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345 (2005) ("The securities statutes seek to maintain public confidence in the marketplace…. They do so by deterring fraud, in part, through the availability of private securities fraud actions."); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("While this language [in Exchange Act §14(a)] makes no specific reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result."); Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) ("Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of §10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements.").

[8] *See, e.g., Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 102d Cong. 15-16 (1991) (quoting then-Chairman Richard C. Breeden as saying "private actions…have long been recognized as a necessary supplement…and an essential tool in the enforcement of federal securities laws. Because the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets.").

[9] *See, e.g.*, Office of Investor Education and Advocacy, Investor Alert: Credit Cards and Investments—A Risky Combination (Feb. 14, 2018), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_riskycombination.

In addition, investors have remedies that may not be available to regulators, the most important of which is the ability to seek full restitution of their losses instead of merely disgorging the bad actor's ill-gotten gains. Resource constraints can also make regulators pick and choose among cases, which means that the government may decline to pursue many viable cases. In short, our regulatory framework assumes that investors themselves will serve an important role in policing the markets.

Advocates for mandatory arbitration suggest that arbitration provides a sufficient way for investors to seek redress, even if investors are denied the right to pursue class action lawsuits. But, as a practical matter, unless a class-wide remedy is available there is often no other recourse for investors with small holdings.[10] Cases involving accounting irregularities or other corporate misdeeds are usually far more complex than the typical dispute involving a consumer contract, or even a dispute against a broker or investment adviser that involves the investor's personal account. For individual investors who suffer losses in a widespread fraud, the costs of bringing claims individually in arbitration may well exceed the amount of the likely recovery. And, unless their losses are sizable, victims will struggle to find attorneys to represent them, much less experts to establish elements such as materiality, reliance, loss causation, and damages. This can lead to a collective action problem, where each investor lacks the economic incentive to bring an individual case, even though the collective losses of multiple investors would justify the costs of the litigation.[11]

Some have observed that class actions generally result in "institutional shareholders effectively suing themselves," paying high costs for the defense while giving plaintiffs' attorneys a large share of any settlement.[12] But institutional investors, who presumably have the economic incentives and resources to pursue individual arbitration, have been vocal in their opposition to forced arbitration. In a recent letter to the SEC, the Council of Institutional Investors expressed its view that these clauses represent a potential threat to principles of sound corporate governance that balance the rights of shareholders against the responsibility of corporate managers to run the business.[13] In my view, there is considerable value in seeing companies held accountable for wrongdoing, even if the compensatory mechanism is imperfect.

[10] The available evidence from other types of forced arbitration provisions bear this out. In the commercial contract context, studies show that far fewer claims are pursued when would-be plaintiffs are limited to arbitration and banned from bringing a class action. For example, a *New York Times* analysis found that in the United States between 2010 and 2014, only 505 consumers went to arbitration over a dispute of $2,500 or less. During that five-year time period, three cell phone and cable TV providers with a combined customer base of nearly 200 million people faced only 78 consumer arbitrations. The *Times* concluded that once people were blocked from going to court as a group, most dropped their claims entirely. Jessica Silver-Greenberg and Robert Gebeloff, *Arbitration Everywhere, Stacking the Deck of Justice*, N.Y. Times, Oct. 31 2015, https://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-deck-of-justice.html.

[11] *See* Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 Fla. L. Rev. 71, 73 (2007).

[12] *See supra* note 5 at 1194.

[13] *See supra* note 2. In an amicus brief submitted by CalPERS and CalSTRS, the two California public pension funds averred that the ability of investors injured by securities fraud to recover through class actions is essential to the integrity of the securities markets and that "[e]viscerating the class action mechanism in securities cases would have disastrous consequences for the amici and their beneficiaries." *See* Brief of the Cal. Pub. Employees' Ret. System et al. as Amici Curiae Supporting Appellees, Conn. Ret. Plans & Tr. Funds v. Amgen Inc., 660 F.3d 1170 (9th Cir. 2011) (No. 09-56965), 2010 WL 4316250. In an amicus brief submitted by several public pension funds in the 2004 Dura Pharmaceuticals v. Broudo Supreme Court case, the institutional investors averred that, notwithstanding the oversight of regulators such as the Commission, "the ability of investors to seek to redress corporate wrongdoing through class and individual actions brought under the Securities Act of 1933 and the Securities Exchange Act of 1934 is an important mechanism to deter improper conduct and to recoup losses that investors have suffered as a result of fraud and other misconduct." *See* Brief of City of N.Y. Pension Funds et al. as Amici Curiae Supporting Respondents, Dura Pharms. Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), 2004 WL 2652613 (statutory citations omitted).

There are other downsides to relying upon individual arbitration as the sole means of recourse. For example, disputes that go to arbitration rather than the court system generally do not become part of the public record, which diminishes their deterrent effect.[14] And, while arbitration is often touted as an efficient means for resolving disputes, it seems terribly inefficient to require multiple plaintiffs to prove up the same claims in separate proceedings.[15] Arbitration also lacks procedural rules that require written opinions or decisions explaining the reasoning for an award, and the grounds for appeal tend to be extremely narrow.[16] As a result, the evolution of case law can be hindered.

Consider, for a moment, how different the federal securities laws would be in the absence of civil litigation. How would we define an investment contract in various fact-specific contexts without the cases that have become our guideposts? Would investors even be able to pursue claims under Rule 10b-5?

As a legal matter, I believe the Commission has been on solid footing when objecting to companies forcing shareholders into arbitration. Securities Act Section 8(a) allows the Commission to refuse to accelerate the effective date of an issuer's registration statement upon considering, among other things, the facility with which the rights of the issuer's securities holders can be understood, the public interest, and the protection of investors. If an issuer chooses to file a registration statement with a forced arbitration provision, I would urge the Commission and staff to make use of Section 8(a).

More broadly, Securities Act Section 14 and Exchange Act Section 29(a) state that any condition that would bind a person to waive compliance with those laws is void. The Supreme Court has upheld the validity of arbitration clauses in brokerage customer agreements, but, for the reasons I've already stated, I would suggest that arbitration is not a viable option for investors—particularly small investors—in cases involving fraud on the market or other corporate misconduct. In my view, if private remedies are an important part of the enforcement mechanisms for the '33 and '34 Acts, and forced arbitration provisions would render those remedies illusory for public company shareholders, then those arbitration provisions are void because they would undermine the enforcement of substantive provisions of the Acts.

Admittedly, there are legal arguments to be made on the other side. The law in this area is messy, particularly in the context of an offering that is reviewed by the SEC, and this specific issue has not been addressed by the Court. But, before public companies push this issue and try to go down this road, it's worth considering where it may ultimately lead. For instance, if investors are blocked from seeking redress in an egregious case, it is not difficult to imagine calls for the SEC to receive greater resources and expanded enforcement powers (such as the ability to seek full restitution) to make up for the loss of private causes of action.

Or, perhaps more likely, investors may pursue other avenues to deter the use of forced arbitration. Not long ago, investors were outraged when a company went public with non-voting

[14] *See supra* note 14.

[15] For example, there is no *stare decisis* or *collateral estoppel*—no legal precedents, and no questions that have been asked and answered. This is an inefficient use of resources because it provides no guidance to other shareholders in virtually identical disputes against the same company, to other companies looking for guidance on their conduct, or to shareholders in other companies.

[16] *See* Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 Sec. Reg. L. J. 181, n. 89 and accompanying text (2008).

shares, and they turned to the index providers for a market solution that would prevent passive investors from being forced to buy the shares. If a company strips away the ability of investors to seek class actions, investors could go down that same road and ask the index providers to keep the company off the index. Before long, if the SEC fails to act, the index providers could step into that vacuum and become the de facto regulators of corporate governance in this country.

Let me close by saying that I hope the Commission does not actually have to confront this issue again in the near future. In my view, the Commission's time would be better spent on matters that address more urgent needs of issuers and their investors. Chairman Clayton, to his credit, has indicated that he is not anxious to expend Commission resources on this issue,[17] and I hope companies are not anxious to push it. For those of you who advise companies that may be curious about adopting mandatory arbitration clauses, I encourage you to talk to them about the downsides and the likely resistance they would encounter from investors and their advocates, including me.

Thank you.

[17] *See* Tom Zanki, *SEC Chief 'Not Anxious' to Deter Post-IPO Class Actions*, Law360 (February 6, 2018, 4:42 PM) https://www.law360.com/articles/1009613/sec-chief-not-anxious-to-deter-post-ipo-class-actions (referring to remarks given by SEC Chairman Jay Clayton at a Senate hearing).

Eclipse of the Public Corporation or Eclipse of the Public Markets?

Posted by Craig Doidge (University of Toronto), on Wednesday, February 21, 2018

Editor's note: Craig Doidge is Professor of Finance at the University of Toronto. This post is based on a paper authored by Professor Doidge; Kathleen M. Kahle, Thomas C. Moses Professor in Finance at the University of Arizona; Andrew Karolyi, Harold Bierman, Jr. Distinguished Professor of Management at Cornell University; and René Stulz, Everett D. Reese Chair of Banking and Monetary Economics at Ohio State University.

In 1989, Jensen wrote that "the publicly held corporation has outlived its usefulness in many sectors of the economy." He published in the *Harvard Business Review* an article titled "The Eclipse of the Public Corporation." Jensen argued that the conflict between owners and managers can make the public corporation an inefficient form of organization. He made the case that new private organizational forms promoted by private equity firms reduce this conflict and are more efficient for firms in which agency problems are severe. Though the number of public firms did not initially fall following Jensen's prediction, it eventually did, and dramatically so.

One might conclude that this dramatic drop in the number of public corporations represents the eclipse of the public corporation as predicted by Jensen. However, large and highly profitable public companies such as Google, Apple, Amazon, Microsoft, and Facebook, have arisen and flourished. Paradoxically, we have some of the most profitable and successful companies in the history of U.S. capital markets at the same time we are witnessing a collapse in the number of public firms. One common characteristic of these firms is that they have vastly more intangible than tangible capital. In our paper, Eclipse of the Public Corporation or Eclipse of the Public Markets?, we argue that U.S. public markets are not well-suited to satisfy the financing needs of young firms with mostly intangible capital. In that sense, what we are really witnessing is not an eclipse of the public corporation, but of the *public markets* as the place where young American companies seek their funding.

We first show the evolution of listings in the U.S. and abroad. In 1975, the number of U.S. domiciled listed firms on the U.S. exchanges was 4,818. This number increased steadily until 1997, when it peaked at 7,509. Since then it has fallen every year but 2014. At the end of 2016, the number of listed firms was 3,618, which is 52% lower than at the peak in 1997. This decline is not a global phenomenon. The number of listed firms in non-U.S. countries has increased since 1997. A regression model that relates the number of listed firms to GDP per capita, GDP growth, and investor rights confirms that the U.S. in recent years indeed has relatively fewer listed firms than other countries with similar characteristics.

For the number of listed firms to fall, there must be fewer new lists and/or more delists. Since 1997 the number of new lists has fallen dramatically and delists have increased. All else equal, new lists are smaller firms and smaller firms are more likely to delist. As a result, the disappearance of small firms from public exchanges has been dramatic. With fewer small firms on public exchanges, the average market capitalization and age of listed U.S. firms has increased.

While the number of listed U.S. firms has declined since 1997, the total number of firms in the economy has increased. Therefore, the propensity to be listed has decreased. While the propensity to be listed decreases for firms of all sizes, the decrease is largest for small firms. Thus, the size distribution of listed firms has tilted towards large firms.

Does this decline in the number of listed U.S. firms really represent an “eclipse of the public corporation”? When Jensen wrote his article in 1989, he was concerned that managers would hoard and waste resources rather than return cash to shareholders. Consistent with this concern, the average ratio of cash holdings to assets for listed firms has increased quite steadily since 1975 and is much higher now compared to previous years. At the same time, listed firms now have extremely high payout rates. They have also changed how they distribute their profits. In 1975, payouts were almost exclusively in the form of dividends. Today, repurchases represent a larger proportion of payouts than dividends. Since 1997, repurchases by listed firms exceed equity issues by $3.6 trillion. These changes make it hard to believe that hoarding of resources by empire-building CEOs is a concern for the corporate sector or that this hoarding explains the drop in listings.

Public firms in the U.S. have evolved in other important ways. We show that, for the typical listed firm, intangible assets are now more important than tangible assets. On average, listed firms spent six times more on capital expenditures than on R&D in 1975. In 2016 they spent twice as much on R&D compared to capital expenditures. Intangible assets are relatively more important for the corporate sector in the U.S. than in other countries.

We argue that public markets are not well-suited for young, R&D-intensive companies. Firms that go public may benefit from having securities registered with the Securities and Exchange Commission. However, public firms are subject to strict disclosure rules and have to follow U.S. Generally Accepted Accounting Principles (GAAP), both of which can be problematic for firms that are heavy in intangible assets. By disclosing details of an R&D program, a firm gives away some of its ideas and other firms can build on what they learn. While firms will try to reveal as little as possible of that which could be appropriated by others, outsiders cannot assess their value correctly if they disclose too little and are likely to value it at a discount. GAAP accounting also makes it difficult for outsiders to assess the value of a firm’s intangible assets.

Firms with valuable intangible assets can better convey information about their value to non-public capital providers. Hence, private forms of equity financing are likely to be preferred by young R&D intensive firms. Regulatory changes, technological changes, and the fact the young firms do not require as much capital in their build-up phase as they used to allows privately-held startups to raise enough capital privately without having to use public markets. Exit through acquisition rather than through public markets has similar advantages for firms with hard-to-value intangible assets.

This evolution has several potential downsides but it also reflects that the financial system of the U.S. has evolved in such a way that some types of firms can be financed more efficiently through private sources. No deregulatory action is likely to restore the public markets in this case. Instead, we should focus on creating a fertile ground for investment in intangible assets by having appropriate laws, appropriate financing mechanisms, and maybe new types of exchange markets, as these assets appear to be the way of the future for corporations.

The complete paper is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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New NYSE Rules For Non-IPO Listings

Posted by Andrew Brady, Phyllis Korff and Michael Zeidel, Skadden, Arps, Slate, Meagher & Flom LLP, on Saturday, February 24, 2018

Editor's note: Andrew Brady and Phyllis Korff are Of Counsel and Michael Zeidel is Partner at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on a Skadden publication by Mr. Brady, Ms. Korff, Mr. Zeidel, and Ryan Adams.

On February 2, 2018, the SEC approved the New York Stock Exchange's proposal to permit qualifying private companies to use "direct listings" to list their shares on the NYSE and become publicly traded without conducting an initial public offering so long as the direct listing is accompanied by a concurrent Securities Act resale registration statement. Direct listings may provide an attractive alternative to a traditional IPO for private companies that do not need to raise public capital but desire to provide greater liquidity for existing shareholders and/or make their shares a more attractive currency for mergers and acquisitions activity.

Background

Traditionally, a company will list on a national securities exchange in connection with a firm commitment underwritten IPO, upon transfer from another market or in connection with a spin-off.

On a case-by-case basis, the NYSE has used rule-based discretion to permit private companies to list their shares in connection with a registration statement filed solely for the purpose of allowing existing shareholders to sell their shares. Listing generally has been permitted if the company had a $100 million aggregate market value of shares held by persons other than directors, officers or their immediate family members based on both (i) an independent third-party valuation (the Valuation) and (ii) the most recent trading price for the company's common stock in a trading system for unregistered securities operated by a national securities exchange or registered broker-dealer (the Private Placement Market). The lesser of these two values has been used to determine if the $100 million threshold is satisfied.

Amended Listing Standards

Exception to the Private Placement Market Requirement

The amended rules aim to address the obstacle faced by certain private companies that otherwise are clearly large enough to be suitable for listing but (i) do not have their shares traded on a Private Placement Market prior to going public; or (ii) the Private Placement Market trading is too limited to provide a reasonable basis for reaching conclusions about a company's qualification. The amended rules remedy this problem by providing an exception to the Private Placement Market trading requirement for companies where there is a recent Valuation available indicating at least $250 million in market value of shares held by persons other than directors, officers or their immediate family members. By adopting a requirement that the Valuation be at least two-and-a-half times the $100 million requirement, the NYSE is seeking to provide a significant degree of comfort that the market value of the company's shares will meet the standard upon commencement of trading. The NYSE argued that this rule change was necessary for it to compete with the Nasdaq composite for listings of large private companies, as Nasdaq's initial listing rules do not explicitly address how Nasdaq determines compliance with its initial listing market capitalization requirements for private companies seeking to list upon effectiveness of a selling shareholder registration statement without a concurrent underwritten public offering.

Tightening the Independence Requirement for the Valuation

Any Valuation used must be provided by an entity that has significant experience and demonstrable competence in providing valuations of companies. To ensure the reliability of the Valuation, the amended rules establish new independence criteria, pursuant to which a valuation agent will not be deemed independent if:

- At the time it provides such valuation, the valuation agent or any affiliated person or persons beneficially own in the aggregate—as of the date of the valuation—more than 5 percent of the class of securities to be listed, including any right to receive any such securities exercisable within 60 days;
- The valuation agent or any affiliated entity has provided any investment banking services to the listing applicant within the 12 months preceding the date of the valuation. "Investment banking services" includes acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs (private investment, public equity transactions) or similar investments; serving as placement agent for the issuer; or acting as a member of a selling group in a securities underwriting; or
- The valuation agent or any affiliated entity has been engaged to provide investment banking services to the listing applicant in connection with the proposed listing or any related financings or other related transactions.

Direct Listing Will Require an Effective Securities Act Registration Statement

The amended rules eliminated a provision that would have allowed a company seeking to make a direct listing to list immediately upon effectiveness of a Securities Exchange Act registration statement only, without any concurrent IPO or Securities Act registration. Thus, under the amended rules, a direct listing will require a company to file a resale registration statement for at least some amount of its outstanding shares, which will be subject to traditional review and comment process of the SEC staff.[1] As is the case with any registered public offering, issuers and their advisers will need to consider the application of the gun-jumping and liability provisions of the Securities Act.

Spin-offs and transfers from another market are not impacted by the new rules.

[1] Public resales by affiliates and nonaffiliates not covered by the resale registration statement must be conducted in accordance with the applicable conditions of Securities Act Rule 144.

Tab V: Investor Attention to Corporate Social Impact

Harvard Law School Forum on Corporate Governance and Financial Regulation

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A Sense of Purpose

Posted by Larry Fink, BlackRock, Inc., on Wednesday, January 17, 2018

Editor's note: Larry Fink is Founder, Chairman and CEO of BlackRock, Inc. This post is based on Mr. Fink's annual letter to CEOs.

Dear CEO,

As BlackRock approaches its 30th anniversary this year, I have had the opportunity to reflect on the most pressing issues facing investors today and how BlackRock must adapt to serve our clients more effectively. It is a great privilege and responsibility to manage the assets clients have entrusted to us, most of which are invested for long-term goals such as retirement. As a fiduciary, BlackRock engages with companies to drive the sustainable, long-term growth that our clients need to meet their goals.

In 2017, equities enjoyed an extraordinary run—with record highs across a wide range of sectors—and yet popular frustration and apprehension about the future simultaneously reached new heights. We are seeing a paradox of high returns and high anxiety. Since the financial crisis, those with capital have reaped enormous benefits. At the same time, many individuals across the world are facing a combination of low rates, low wage growth, and inadequate retirement systems. Many don't have the financial capacity, the resources, or the tools to save effectively; those who are invested are too often over-allocated to cash. For millions, the prospect of a secure retirement is slipping further and further away—especially among workers with less education, whose job security is increasingly tenuous. I believe these trends are a major source of the anxiety and polarization that we see across the world today.

We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

A new model for corporate governance

Globally, investors' increasing use of index funds is driving a transformation in BlackRock's fiduciary responsibility and the wider landscape of corporate governance. In the $1.7 trillion in active funds we manage, BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth. In managing our index funds, however, BlackRock cannot express its disapproval by selling the company's securities as long as that company remains in the relevant index. As a result, our responsibility to engage and vote is more important than ever. In this sense, index investors are the ultimate long-term investors—providing patient capital for companies to grow and prosper.

Just as the responsibilities your company faces have grown, so too have the responsibilities of asset managers. We must be active, engaged agents on behalf of the clients invested with BlackRock, who are the true owners of your company. This responsibility goes beyond casting proxy votes at annual meetings—it means investing the time and resources necessary to foster long-term value.

The time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own. I have written before that companies have been too focused on quarterly results; similarly, shareholder engagement has been too focused on annual meetings and proxy votes. If engagement is to be meaningful and productive—if we collectively are going to focus on benefitting shareholders instead of wasting time and money in proxy fights—then engagement needs to be a year-round conversation about improving long-term value.

BlackRock recognizes and embraces our responsibility to help drive this change. Over the past several years, we have undertaken a concentrated effort to evolve our approach, led by Michelle Edkins, our global head of investment stewardship. Since 2011, Michelle has helped transform our practice from one predominantly focused on proxy voting towards an approach based on engagement with companies.

The growth of indexing demands that we now take this function to a new level. Reflecting the growing importance of investment stewardship, I have asked Barbara Novick, Vice Chairman and a co-founder of BlackRock, to oversee the firm's efforts. Michelle will continue to lead the global investment stewardship group day-to-day. We also intend to double the size of the investment stewardship team over the next three years. The growth of our team will help foster even more effective engagement with your company by building a framework for deeper, more frequent, and more productive conversations.

Your strategy, your board, and your purpose

In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth. I want to reiterate our request, outlined in past letters, that you publicly articulate your company's strategic framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors. This demonstrates to investors that your board is engaged with the strategic direction of the company. When we meet with directors, we also expect them to describe the Board process for overseeing your strategy.

The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to climate change—affect your potential for growth.

These strategy statements are not meant to be set in stone—rather, they should continue to evolve along with the business environment and explicitly recognize possible areas of investor dissatisfaction. Of course, we recognize that the market is far more comfortable with 10Qs and colored proxy cards than complex strategy discussions. But a central reason for the rise of activism—and wasteful proxy fights—is that companies have not been explicit enough about their long-term strategies.

In the United States, for example, companies should explain to investors how the significant changes to tax law fit into their long-term strategy. What will you do with increased after-tax cash flow, and how will you use it to create long-term value? This is a particularly critical moment for companies to explain their long-term plans to investors. Tax changes will embolden those activists with a short-term focus to demand answers on the use of increased cash flows, and companies who have not already developed and explained their plans will find it difficult to defend against these campaigns. The U.S. tax bill is only one such example—regardless of a company's jurisdiction, it is your responsibility to explain to shareholders how major legislative or regulatory changes will impact not just next year's balance sheet, but also your long-term strategy for growth.

Where activists do offer valuable ideas—which is more often than some detractors suggest—we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

The board's engagement in developing your long-term strategy is essential because an engaged board and a long-term approach are valuable indicators of a company's ability to create long-term value for shareholders. Just as we seek deeper conversation between companies and shareholders, we also ask that directors assume deeper involvement with a firm's long-term strategy. Boards meet only periodically, but their responsibility is continuous. Directors whose knowledge is derived only from sporadic meetings are not fulfilling their duty to shareholders. Likewise, executives who view boards as a nuisance only undermine themselves and the company's prospects for long-term growth.

We also will continue to emphasize the importance of a diverse board. Boards with a diverse mix of genders, ethnicities, career experiences, and ways of thinking have, as a result, a more diverse and aware mindset. They are less likely to succumb to groupthink or miss new threats to a company's business model. And they are better able to identify opportunities that promote long-term growth.

Furthermore, the board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.

Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?

As we enter 2018, BlackRock is eager to participate in discussions about long-term value creation and work to build a better framework for serving all your stakeholders. Today, our clients—who are your company's owners—are asking you to demonstrate the leadership and clarity that will drive not only their own investment returns, but also the prosperity and security of their fellow citizens. We look forward to engaging with you on these issues.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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BlackRock Talks … and U.S. Companies Must Listen

Posted by Ed Batts, Orrick, Herrington & Sutcliffe LLP, on Tuesday, February 13, 2018

Editor's note: Ed Batts is partner and Chair of the M&A and Private Equity groups at Orrick, Herrington & Sutcliffe LLP. This post is based on an Orrick publication by Mr. Batts. Related research from the Program on Corporate Governance includes The Agency Problems of Institutional Investors by Lucian Bebchuk, Alma Cohen, and Scott Hirst; and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

In BlackRock CEO and Co-founder Larry Fink's annual letter to companies on January 16, he issued a call to action for companies to have "a clear sense of purpose." To BlackRock, having "a clear sense of purpose" means much more than simply delivering quarterly financial results—companies will be expected to have a strong commitment to evolving Environmental, Social and Governance (ESG) issues.

This letter matters both because BlackRock is an important large investor of actively managed assets and—more importantly—because we are living in a new world order of many fewer public companies with, at the same time, a continued crescendo of passive investment allocation. These changes in the U.S. equities markets have been underway for some time, but with the recent significant bull market run they are being magnified at an accelerated pace.

Below is a quick tour of how we got here. And then we discuss the take-away: For the foreseeable future, companies and their boards need to be in dialogue with passive investors' governance departments. And they need to be prepared for a conversation in which ESG issues are squarely on the agenda.

Part I: The Revolution in U.S. Equity Markets

Pre-Index Investing

In the "old" days (think when EF Hutton was making those "people listen" commercials), a company's stockholders were divided into:

- **Active/Fundamental Mutual Funds** (e.g. Fidelity, T. Rowe, Wellington)
- **Hedge Funds** (e.g. Tiger Management, Bridgewater Associates)
- **Pension Funds** (e.g. CalPERS/CalSTRS, Ontario Teachers' Pension Plan)
- **Labor Funds** (a.k.a. Taft-Hartley multi-employer funds) (e.g. Service Employees International Union or the Sheet Metal Workers International Association)
- **Activist Investors** (essentially a subset of hedge) (e.g. Carl Icahn and Nelson Peltz)
- **Retail Investors**
- **Insiders/Management**

The Ongoing Massive Shift in U.S. Equities Ownership

Two market phenomena have radically altered that landscape.

First, ***the number of actors/companies in which broad-market passive funds may invest has roughly halved, while average market capitalization has more than tripled***.

- The total number of domestic public companies has shrunk from over 8,100 in 1996 to 4,300 today (*World Bank/World Federation of Exchanges*). That essentially eliminates half the domestic (non-foreign listing) investment targets in the U.S. And foreign companies listed in the U.S. add only 900.
- Total U.S. domestic equity market value in that same twenty-year period has doubled, from just over $12 trillion to $27 trillion (held constant in 2017 dollars) *(Credit Suisse)*, going from 105 percent to 147 percent of annual U.S. GDP (*World Bank/World Federation of Exchanges*).
- Commensurately, to balance out fewer companies with greater total value, average domestic public market capitalization of a given public company has increased from $1.7 billion to over $6.9 billion in constant dollars (*Credit Suisse*). Median value is $832 million—and that median value is essentially what market observers would posit is the minimum value necessary for a public company to have scale and liquidity in its public float (*E&Y*).
- The top 1 percent of domestic public companies—roughly 30 companies—account for 29 percent of aggregate market value (*E&Y*).
- The top 4 percent of domestic public companies—roughly 130 companies, each of which is worth more than $50 billion—account for over 50 percent of aggregate market value (*E&Y*).
- To draw further conclusions: Roughly 1,650 domestic public companies are under $832 million in market capitalization. That leaves approximately 1,500 companies “in the middle”—a middle that ranges vastly from roughly $1 billion to $50 billion. And this is the concentrated set of companies on which the broad-based passive index funds by definition must be focused.

Second, as “the market” has decreased in number of actors/companies, ***it has been flooded with allocation to passive vehicles***, whether Exchange Traded Funds (ETFs, whose prices fluctuate intra-day on a securities exchange) or mutual funds (whose prices are calculated once a day after market close):

- *Total Market Value*: More than 40 percent of U.S. equity assets under management (AUM) are in passive vehicles (*Goldman Sachs*) and, out of the entire U.S. equity market (professionally held plus individually invested), 30 percent are in passive vehicles (*Morningstar*).
- *Concurrent Decline in Individual Ownership:* Individual ownership has dropped precipitously from ½ of the market to 1/5 of the market—50 percent in 1976, 27 percent in 1996 and 21.5 percent in 2006 (*Credit Suisse).*
- *Trend*: In 2016, $506 billion flowed into passive funds, while $341 billion was hemorrhaged from active funds (*Morningstar*).

- *Trading Volume*: 25 percent of daily trading volume on U.S. exchanges is in ETFs—not actual stocks (*Goldman Sachs*). There were 2 ETFs in 1996. There were 658 as of 2016, and the number is growing (*Credit Suisse)*.

The three largest passive investment management firms are (with numbers as of September 30, 2017—and no doubt increased since then):

- **BlackRock, New York City:** Out of almost $6 trillion AUM, $1.2 trillion is in the popular iShares equity-based ETFs (which tripled since BlackRock purchased the business from Barclays in 2009); another $1.6 trillion is in institutional passive equity funds. BlackRock, then, holds $2.8 trillion in passive equity strategy vehicles. While BlackRock does not report specific geographic investment mix, a rough approximation would be that some 70 percent of it is likely in U.S. markets (BlackRock 3Q18 Form 10-Q).
- **Vanguard, Valley Forge, Pennsylvania:** $4.5 trillion AUM—the vast majority in U.S. index investing. Its founder, Jack Bogle—after having been fired from active manager Wellington—was the original primary advocate of indexing and created an index giant. In contrast, its large fundamental-based mutual fund competitor, Fidelity, has under $2 trillion AUM. Four of five of the largest U.S. mutual funds are index funds from Vanguard—the fifth is Fidelity's money market fund—an investment in essentially cash, not portfolio management (*Investopedia*). In the past three years, Vanguard received about 85 percent of all new U.S. mutual fund investment money, while the remaining 15 percent went to all of Vanguard's other 4,000 mutual fund competitors <u>all combined</u> (*Morningstar/The New York Times*).
- **State Street Global Advisors (SSgA), Boston:** $2.6 trillion AUM of which 70 percent is in North America, $1.5 trillion in passive equity. State Street, while separately a behemoth in third party securities custodianship, remains the smallest of the passive investment management shops—but has the well-known SPDR ETFs.

The result is that passive investment management firms now hold massive portions (closing in on 1/3) of U.S. equities. And because they are passive, they cannot summarily buy—or sell. Once a passive fund purchases an equity, it is there to stay … forever … unless the company runs into so much trouble as to fall off the particular index. A passive fund's holdings may fluctuate with overall investment levels in U.S. equities; however, a passive fund's ownership level relative to other investors is unlikely to materially change and, in fact, given the seeming march towards greater value, such fluctuations of late have meant only increased ownership levels as "dry powder" continues to aggressively enter the markets.

Part II: Three Ground Rules for Companies Living in a New World Order of Passive Investing

Ground Rule #1: Each of the "Big 3" Passive Shops Has an In-House Governance Function. Get to know them well in advance—to avoid barely getting a short, rushed meeting with them when it is crunch time.

As of January 2018, the heads of these departments (referred to as "Investment Stewardship") were:

- **BlackRock: *Michelle Edkins***, who Larry Fink announced in his message will be supplemented by BlackRock's Vice Chairman and Co-founder, ***Barbara Novick***. Ms. Edkins is a New Zealander who began in investment management in 1997 in the UK and joined BlackRock in 2009.
- **Vanguard: *Glenn Booream***, who joined Vanguard directly from college in 1989.
- **SSgA**: ***Rakhi Kumar***, a former chartered accountant in India who picked up an MBA from Yale and worked for Moody's before spending the last seven years at SSgA.

Ground Rule #2: Passive Investors' Influence Cannot Be Underestimated.

Take, for example, the heated October 2017 proxy contest between Proctor & Gamble and Nelson Peltz's Trian Management. P&G's share ownership falls out as (data from *Proxy Insight*; shares rounded to nearest million):

- Passives: Vanguard (187 million), BlackRock (159 million) and SSgA (113 million): They are #1-3 of the top stockholders—and the next largest holder is Bank of America at a distant 44 million.
- Major Actives (cross-section based on past importance/author experience): Capital, Dimensional, Fidelity, T.Rowe, TIAA-CREF and Wellington, <u>all combined</u>: 106 million.
- Teacher and state/municipal employee pension funds in California, Florida, New York, Ontario and Texas, <u>all combined</u>: 29 million.
- In other words, the most well-known active funds and major pension funds <u>all combined</u> hold 135 million shares in P&G—versus the smallest of the major 3 passive positions, SSgA, at 113 million shares.

All of the intensive proxy solicitation and lobbying effort invested into hitherto major (and still relatively large) funds spread throughout North America can be matched or dwarfed in a single vote from a passive investment management company.

Ground Rule #3: Passive Shops Are Independent Thinkers Who Do Not Necessarily Follow the Herd. Moreover, ISS and Glass Lewis No Longer Are the Undisputed Shepherds of the Herd.

Historically, fundamental/active fund portfolio managers focused almost exclusively on quantitative return of equity value. Beginning in the late 1980s, however, the U.S. Department of Labor's Pension and Welfare Benefits Administration—exercising its jurisdiction for retirement plan investments through ERISA—issued advisory letters in *Avon* (1988) and *Monks* (1990) and then a 1994 Interpretive Bulletin, which cumulatively resulted as a practical matter in forcing investment advisers to vote. From *Avon*: "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." Rather than each investment adviser devoting the significant resources to establishing individual corporate governance departments to vote on thousands of annual proxies, most instead outsourced the substantive analysis to proxy advisory firms, first ISS and then its later arch rival, Glass Lewis. These outsourced proxy advisory firms for many years reigned supreme, particularly with ISS's near-monolithic dominance of vote recommendations for funds.

Such hegemony has substantially eroded. Using the recent P&G context example, while both ISS and Glass Lewis recommended voting in favor of Mr. Peltz, P&G's single largest shareholder, Vanguard, reportedly ignored those recommendations and voted with P&G management's slate of directors. After a *very*, *very* close vote, Mr. Peltz ultimately was seated on the P&G board. This also shows that while the Big 3 passives matter, if they split—then every vote from non-passive stockholders suddenly becomes mathematically critical. Try hard to avoid ignoring or making an enemy of any institutional stockholder.

BlackRock's 2018 Annual Letter to Companies

Index investing is an interesting commercial environment, since the primary historical factor for investing—seeking individual equity or fund return/Alpha—is stripped from consideration. Instead, fund expenses become key—but there are only so many fractions of a basis point to cut further before the expenses are very similar among competitors—and very, very cheap, at least in contrast to active trader funds or the steep carry and management fees of hedge funds. After two years of steep outflows and sub-market returns, hedge funds have stabilized of late—but even so, *Boston Consulting Group* is forecasting that a reasonable bad case—where hedge returns continue to suffer as they did in the past couple of years—could entail a further 30 percent shrinkage in hedge AUM by 2020. Conversely, keep in mind that, according to *The New York Times*, Vanguard has one employee (in any function …) for every approximately $44 billion of AUM—and that Vanguard's indices have significantly outperformed hedge fund median returns in this bull market.

In recent years, SSgA has increasingly differentiated itself from index fund purchasers by advocating for attention to Environmental, Social and Governance (ESG) issues. And while BlackRock certainly has not avoided the subject, it hitherto did not issue as clear a call to action. Indeed, while many similar themes were raised in last year's annual letter, they were couched in more gentle coaxing, rather than this year's direct call to action:

"Furthermore, the board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company's ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.

"Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?"

What Does This Mean in Practice?

There undoubtedly is a hypothetical saturation point at which macro-economic headwinds and increasing concentration of equity ownership in passive investment funds will collide—where too much investing dollars could be postulated to be “stranded” in rule-based investing at much more higher levels than indices are now in the aggregate. This potentially could create greater volatility since wholesale rotation out of equities entirely, rather than from one stock to another, seems more likely when dumping an index. Perhaps then, “seeking alpha” (and a bit more of Buffet’s value investing) may return with vengeance.

But don’t bet on it anytime soon. If anything, we appear headed for significant macro-economic tailwinds for the near future. As but one indicator, the new tax bill will likely significantly bolster equity prices, as both lower domestic effective tax rates and repatriation of foreign cash will likely be used to both repurchase stock and provide tidy sums for either dividends or fights over capital allocation strategies with activist investors—buckle up! A rising tide of equity prices raises all ships—and a continuing bull market is unlikely to shake investors’ seemingly unending appetite for smile-inducing returns from low cost, low hassle passive funds—further concentrating voting.

Companies need to expect:

- The continued need to **engage in discussion routinely** with governance departments. In fact, **ask to do so**.
- One or more **independent directors to be part of those discussions**. Depending on the circumstance, it may be necessary to give an investment steward the opportunity to talk without the CEO present for some part of the conversation—still a generally unpopular concept with management.
- **Pointed questions on board diversity**—gender and racial in particular—as well as pay equity.
- To **substantively engage on environmental topics**, such as climate change impact.

The road shows of yesteryear meant relatively narrow lanes of traipsing up and down the Northeastern Corridor—from Baltimore to New York and then Philly to Boston—to perform a pilgrimage to a few portfolio active fund managers and review a financial model. Now management—and importantly, board members—get to add passive shops to their tours. The sooner that boards and, of course, management accept a new reality driven by enormous underlying market dynamics, the sooner they will adapt to a new power structure that increasingly looks far beyond EPS guidance.

JANA PARTNERS LLC

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

January 6, 2018

Board of Directors
Apple Inc.
1 Infinite Loop
Cupertino, California 95014

Ladies & Gentlemen,

JANA Partners LLC and the California State Teachers' Retirement System ("we" or "us") collectively own approximately $2 billion in value of shares of Apple Inc. ("Apple" or "you"). As shareholders, we recognize your unique role in the history of innovation and the fact that Apple is one of the most valuable brand names in the world. In partnership with experts including Dr. Michael Rich, founding director of the Center on Media and Child Health at Boston Children's Hospital/Harvard Medical School Teaching Hospital and Associate Professor of Pediatrics at Harvard Medical School, and Professor Jean M. Twenge, psychologist at San Diego State University and author of the book *iGen*, we have reviewed the evidence and we believe there is a clear need for Apple to offer parents more choices and tools to help them ensure that young consumers are using your products in an optimal manner. By doing so, we believe Apple would once again be playing a pioneering role, this time by setting an example about the obligations of technology companies to their youngest customers. As a company that prides itself on values like inclusiveness, quality education, environmental protection, and supplier responsibility, Apple would also once again be showcasing the innovative spirit that made you the most valuable public company in the world. In fact, we believe that addressing this issue now will enhance long-term value for all shareholders, by creating more choices and options for your customers today and helping to protect the next generation of leaders, innovators, and customers tomorrow.

More than 10 years after the iPhone's release, it is a cliché to point out the ubiquity of Apple's devices among children and teenagers, as well as the attendant growth in social media use by this group. What is less well known is that there is a growing body of evidence that, for at least some of the most frequent young users, this may be having unintentional negative consequences:

- A study conducted recently by the Center on Media and Child Health and the University of Alberta found that 67% of the over 2,300 teachers surveyed observed that the number of students who are negatively distracted by digital technologies in the classroom is growing and 75% say students' ability to focus on educational tasks has decreased. In the past 3 to 5 years since personal technologies have entered the classroom, 90% stated that the number of students with emotional challenges has increased and 86% said the number with social challenges has increased. One junior high teacher noted that, "I see youth who used to go outside at lunch break and engage in physical activity and socialization. Today, many of our students sit all lunch hour and play on their personal devices."[i]

- Professor Twenge's research shows that U.S. teenagers who spend 3 hours a day or more on electronic devices are 35% more likely, and those who spend 5 hours or more are 71% more likely, to have a risk factor for suicide than those who spend less than 1 hour.[ii]
- This research also shows that 8th graders who are heavy users of social media have a 27% higher risk of depression, while those who exceed the average time spent playing sports, hanging out with friends in person, or doing homework have a significantly lower risk. Experiencing depression as a teenager significantly increases the risk of becoming depressed again later in life.[iii]
- Also, teens who spend 5 or more hours a day (versus less than 1) on electronic devices are 51% more likely to get less than 7 hours of sleep (versus the recommended 9). Sleep deprivation is linked to long-term issues like weight gain and high blood pressure.[iv]
- A study by UCLA researchers showed that after 5 days at a device-free outdoor camp, children performed far better on tests for empathy than a control group.[v]
- According to an American Psychological Association (APA) survey of over 3,500 U.S. parents, 58% say they worry about the influence of social media on their child's physical and mental health, 48% say that regulating their child's screen time is a "constant battle," and 58% say they feel like their child is "attached" to their phone or tablet.[vi]

Some may argue that the research is not definitive, that other factors are also at work, and that in any case parents must take ultimate responsibility for their children. These statements are undoubtedly true, but they also miss the point. The average American teenager who uses a smart phone receives her first phone at age 10[vii] and spends over 4.5 hours a day on it (excluding texting and talking).[viii] 78% of teens check their phones at least hourly and 50% report feeling "addicted" to their phones.[ix] It would defy common sense to argue that this level of usage, by children whose brains are still developing, is not having at least some impact, or that the maker of such a powerful product has no role to play in helping parents to ensure it is being used optimally. It is also no secret that social media sites and applications for which the iPhone and iPad are a primary gateway are usually designed to be as addictive and time-consuming as possible, as many of their original creators have publicly acknowledged.[x] According to the APA survey cited above, 94% of parents have taken some action to manage their child's technology use, but it is both unrealistic and a poor long-term business strategy to ask parents to fight this battle alone. Imagine the goodwill Apple can generate with parents by partnering with them in this effort and with the next generation of customers by offering their parents more options to protect their health and well-being.

To be clear, we are not advocating an all or nothing approach. While expert opinions vary on this issue, there appears to be a developing consensus that the goal for parents should be ensuring the *developmentally optimal* amount and type of access, particularly given the educational benefits mobile devices can offer. For example, Professor Twenge's research cited above has revealed peak mental health levels among teenagers who use devices 1 hour or less a day, with teens engaging in this limited use happier than teens who do not use devices at all. According to a study of more than 10,000 North American parents conducted by researcher Alexandra Samuel, the children of parents who focus primarily on denying screen access are more likely to engage in problematic behaviors online than the children of parents who take an active role in guiding their technology usage.[xi] Likewise, researchers at the University of Pittsburgh Center for Research on

Media, Technology, and Health have found that while using a high number of social media platforms daily is linked to depression and anxiety in young adults, using a limited number does not have the same impact.[xii]

While these studies (and common sense) would suggest a balanced approach, we note that Apple's current limited set of parental controls in fact dictate a more binary, all or nothing approach, with parental options limited largely to shutting down or allowing full access to various tools and functions. While there are apps that offer more options, there are a dizzying array of them (which often leads people to make no choice at all), it is not clear what research has gone into developing them, few if any offer the full array of options that the research would suggest, and they are clearly no substitute for Apple putting these choices front and center for parents. As Apple understands better than any company, technology is best when it is intuitive and easy to use. More importantly, technology will continue to evolve as time goes on and play a greater and greater role in all of our lives. There is a developing consensus around the world including Silicon Valley that the potential long-term consequences of new technologies need to be factored in at the outset, and no company can outsource that responsibility to an app designer, or more accurately to hundreds of app designers, none of whom have critical mass.

This is a complex issue and we hope that this is the start of a constructive and well-informed dialogue, but we think there are clear initial steps that Apple can follow, including:

- *Expert Committee:* Convening a committee of experts including child development specialists (we would recommend Dr. Rich and Professor Twenge be included) to help study this issue and monitor ongoing developments in technology, including how such developments are integrated into the lives of children and teenagers.
- *Research:* Partnering with these and other experts and offering your vast information resources to assist additional research efforts.
- *New Tools and Options:* Based on the best available research, enhancing mobile device software so that parents (if they wish) can implement changes so that their child or teenager is not being handed the same phone as a 40-year old, just as most products are made safer for younger users. For example, the initial setup menu could be expanded so that, just as users choose a language and time zone, parents can enter the age of the user and be given age-appropriate setup options based on the best available research including limiting screen time, restricting use to certain hours, reducing the available number of social media sites, setting up parental monitoring, and many other options.
- *Education:* Explaining to parents why Apple is offering additional choices and the research that went into them, to help parents make more informed decisions.
- *Reporting:* Hiring or assigning a high-level executive to monitor this issue and issuing annual progress reports, just as Apple does for environmental and supply chain issues.

It is true that Apple's customer satisfaction levels remain incredibly high, which is no surprise given the quality of its products. However, there is also a growing societal unease about whether at least some people are getting too much of a good thing when it comes to technology,[xiii] which at some point is likely to impact even Apple given the issues described above. In fact, even the original designers of the iPhone user interface and Apple's current chief design officer have publicly worried about the iPhone's potential for overuse,[xiv] and there is no good reason why you should not address this issue proactively. As one of the most innovative companies in the history of technology, Apple can play a defining role in signaling to the industry that paying special attention to the health and development of the next generation is both good business and the right thing to do. Doing so poses no threat to Apple, given that this is a software (not hardware) issue and that, unlike many other technology companies, Apple's business model is not predicated on excessive use of your products. In fact, we believe addressing this issue now by offering parents more tools and choices could enhance Apple's business and increase demand for its products.

Increasingly today the gap between "short-term" and "long-term" thinking is narrowing, on issues like public health, human capital management, environmental protection, and more, and companies pursuing business practices that make short-term sense may be undermining their own long-term viability. In the case of Apple, we believe the long-term health of its youngest customers and the health of society, our economy, and the Company itself, are inextricably linked, and thus the only difference between the changes we are advocating at Apple now and the type of change shareholders are better known for advocating is the time period over which they will enhance and protect value. As you can imagine, this is a matter of particular concern for CalSTRS' beneficiaries, the teachers of California, who care deeply about the health and welfare of the children in their classrooms.

While you may already have started work on addressing the issues raised here, we would nonetheless appreciate the opportunity to discuss this matter further with the board to bring in a wider range of voices. We also encourage you to discuss this matter directly with Dr. Rich, Professor Twenge, or any member of JANA's board of advisors for our new impact investing fund, which includes Patricia A. Daly, OP, Professor Robert G. Eccles, Sting, and Trudie Styler. In the meantime, should you wish to contact us we can be reached at (212) 455-0900 or (916) 414-7410.

Sincerely,

Barry Rosenstein	Anne Sheehan
Managing Partner	Director of Corporate Governance
JANA Partners LLC	The California State Teachers' Retirement System

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[i] "*Growing Up Digital Alberta*". A collaborative research project by Harvard Medical School Teaching Hospital, the Center on Media and Child Health, Boston Children's Hospital, University of Alberta, and the Alberta Teachers' Association (2016)

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[iv] *Id.*

[v] Yalda T. Uhls, Minas Michikyan, Jordan Morris, Debra Garcia, Gary W. Small, Eleni Zgourou, & Patricia M. Greenfield. "Five days at outdoor education camp without screens improves preteen skills with nonverbal emotion cues." *Computers in Human Behavior Journal* (Oct. 2014): 387-392

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Activists and Socially Responsible Investing

Posted by Charles Nathan, Finsbury LLC, on Tuesday, January 30, 2018

Editor's note: Charles Nathan is a senior advisor at Finsbury LLC, and an adjunct professor of law at Yale Law School and Columbia Law School. This post is based on a commentary by Mr. Nathan. Related research from the Program on Corporate Governance includes Who Bleeds When the Wolves Bite? By Leo E. Strine, Jr. (discussed on the Forum here), and Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

At first blush, activists embracing socially responsible investing sounds like an oxymoron. After all, a common perception is that activist investors are solely financial engineers who seek short-term stock market gains by leveraging balance sheets, selling off valuable corporate assets and imprudent cost-cutting of R&D and other long-term value creators. What could be farther from short-term financial engineering than socially responsible investing, which typically looks to a much longer-term impact on the company's financial and commercial performance?

However, like so much in life, the real world is far more complicated and harder to categorize. First, many activist campaigns are not about financial engineering in any sense. While activists sometimes do campaign on platforms that include (or perhaps consist principally of) cost-cutting, far from all of these are imprudent cost reductions at the expense of long-term growth. More important, many activist campaigns focus on building the business through better organizational structures and/or more effective focus on improving the quality of goods and services. Indeed, the latter type of activist investor policy has been in the ascendant among leading activist investors for several years now.

But even so, a focus on organizational, operational and product improvement seems a far cry from socially responsible investing. So it attracted some notice when Trian Partners modified its web site last year to add a statement embracing ESG and a compendium of ESG highlights at its current portfolio companies. For example:

> "Trian believes that ESG issues can have an impact on a company's culture and long-term performance and that companies can implement appropriate ESG initiatives that increase their sales and earnings."
>
> "We also believe that ***the consideration of ESG factors enhances our overall investment process***."

Trian's ESG investment policy does not seem significantly different from the ESG investment policies of many leading institutional investors, particularly the largest index investors (e.g., BlackRock, Vanguard and State Street). Indeed, the examples of its ESG investing which Trian provides on its website could as easily have been posted by a conventional institutional investor highlighting its ESG initiatives, such as promoting diversity in the workforce, director independence, board refreshment, emission and waste reduction and adoption of supplier codes of conduct.

The similarity of Trian's ESG policy to that of other major institutional investors suggests it has two complementary purposes.

- First, an increasing number of institutional investors believe that a company's economic performance and stock market valuation is frequently dependent on specific ESG issues inherent in its business model and are thus integral to any investment decision involving the company. It is natural for Trian as a value investor to subscribe to this investing policy.
- Second, the success of Trian's activist business model depends on support for its company specific campaigns from traditional long institutional investors. In this view, Trian's very public embrace of ESG investing can be viewed as courting, in particular, the three major index investors (all of whom are staunch supporters of ESG investing), as well as state and local pension funds, union pension funds and other core corporate governance activists who almost universally champion ESG investing.

More recently and far more dramatically than Trian's embrace of ESG investing, Jana Partners published a joint letter with CalSTRS calling on Apple to recognize the potential dangers to children and teenagers of too frequent use and abuse of their iPhones and to implement a far-reaching program of research on the effects of excessive social media use by youngsters as well as far more sophisticated and effective programming choices on iPhones to enable parents to limit the devices' usage by their children.

In addition, Jana announced that it was planning to raise a new fund, called Jana Impact Capital. According to a press report, the new Jana fund is targeted at $1.7 billion and would invest in companies that "are good bets but could do better for the world. The fund's board of advisers includes Sting and others who have a track record of pressuring companies on environmental, social and governance issues."

The Jana and CalSTRS campaign at Apple, and presumably the investment thesis of its proposed Impact Fund, are clearly of a different order from Trian's approach to ESG investing. Jana is not merely taking ESG into account in its investment analysis, it is going a significant step further by using one or several ESG issues as the fulcrum of its activist campaign. The obvious questions are what is Jana hoping to accomplish and what are the possible impediments to its goals?

An obvious answer would be to foster positive ESG change at a target company thereby enhancing the value of Jana's equity position. There are, however, at least two underlying problems with this explanation.

- Will the ESG issue championed by Jana resonate sufficiently with other investors to motivate the target company to adopt the proposed policy change without requiring more aggressive moves by Jana? The answer is more complicated than it might initially seem. It is probably yes, if there is broad institutional investor support and the change doesn't materially alter the company's business model. But if that's the case, how likely is the change to produce a sufficient up-tick in the company's stock price to justify the activist campaign?

- On the other hand, if the company rejects the proposed ESG change, will it matter enough to enough shareholders to give credence to further more aggressive agitation by the activist? Historically, ESG issues have not been viewed as sufficiently connected to value to create this sort of leverage for its proponents. Will Jana be able to identify ESG issues that have so much appeal to institutional shareholders that the ESG issues can serve as the fulcrum for a threatened or actual proxy contest?

There is, however, another, somewhat cynical, explanation of Jana's ESG strategy. As one commentator speculated:

> "The [Apple campaign] will almost certainly help Rosenstein [the head of Jana] as he seeks capital allocations from public pension funds for his traditional activist fund and its more aggressive, less friendly agitations….Also, it could help Jana Partners gain support for its campaigns in the form of votes of big institutional investors…The [Apple] campaign fits squarely within the category of…ESG, an investing category that sizeable public pension funds such as CalSTRS as well as the primary index funds, including Vanguard Group, State Street, and BlackRock, are concentrating on heavily."

This speculation about Jana's motives also notes that the Jana's new fund will not charge investors the traditional hedge fund "2 and 20"—that is a fee equal to 2% of the investment plus 20% of the profits. Rather, according to press reports its fee structure will be just 2% of invested fund with no success fee. The supposition is that the proposed fee structure illustrates that Jana is not counting on its ESG activism to achieve profits of the same order as its more traditional activist investing. Rather, Jana's principal purpose is to create a "halo" effect that will advance Jana's traditional activist investing model in terms of support for its activist campaigns by and its asset gathering from the larger index investors and state, local and union pension funds.

The more cynical explanation of Jana's strategy has its flaws, as well. It ignores that Jana's business model, both as an asset gatherer and as an activist investor, is wholly dependent on its ability to provide outsize returns for its investors. Creating an ESG fund that doesn't and isn't intended do this may adversely affect its conventional asset gathering. Moreover, Jana's credibility and success as an activist investor is clearly based in large part on its history as a successful and to be feared opponent. A history of issuer friendly ESG investing (as it seemingly is positioning its Apple foray) and/or of failed activist ESG campaigns will not burnish its record as a conventional "to be feared" activist investor.

If Jana's strategy and the success of that strategy are murky, so is the play book for its corporate targets. Right now, the strategy is too new and uncertain to make useful predictions, let alone develop prototype company response playbooks. At least initially, a company that is targeted by an activist ESG campaign will have to evaluate its situation against a relatively blank slate in terms of prior experience. Moreover, its response will have to be tailored to the precise ESG issue it is facing and the economic consequences of its acceding to or contesting the proposal. For Apple to embrace the Jana/CalSTRS proposals would not be the same as Exxon agreeing to an ESG based proposal to cease its ocean-based oil drilling and production. The only sensible advice for companies worrying about the implications of Jana's attempt to create an ESG based version of activist investing is simply to "stay tuned to the program."

Environmental and Social Proposals in the 2017 Proxy Season

Posted by Thomas Singer, The Conference Board, Inc., on Thursday, October 26, 2017

Editor's note: Thomas Singer is a principal researcher in corporate leadership at The Conference Board, Inc. This post is based on a publication from The Conference Board, authored by Mr. Singer and Ramsha Khursheed. Related research from the Program on Corporate Governance includes Social Responsibility Proposals by Scott Hirst (discussed on the Forum here).

The Conference Board recently released a report that reviews the key environmental and social (E&S) proposals in the 2017 proxy season. The report provides details on some of the most prominent topics, including topics which received high levels of shareholder support and topics that have seen notable changes in support levels compared to previous years.

The report reviews the period between January 1 and June 30, 2017. Of the 465 voted proposals brought to shareholders at Russell 3000 companies 201 related to E&S issues, making up 43.2 percent of proposals brought to a vote during this period. The report finds the volume of E&S proposals has consistently gone up in the past five years.

Although proposals on E&S issues received average support of only 21.4 percent of votes cast in 2017, support levels for these proposals continue an upward trend. For instance, in 2016 these proposals received average support of 19.7 percent of votes cast. The number of E&S proposals that have won majority support has also increased over the last few years: six proposals passed in 2017, compared to four in 2016 and four in 2013. The E&S topics that had successful proposals this year were recently summarized in a column on Chief Executive.

The uptick in successful E&S proposals can largely be attributed to a shift in the voting policies of traditionally passive investors. Large institutional investors, such as BlackRock and Vanguard, are beginning to exert pressure on companies by supporting E&S proposals that call for greater disclosure of issues they deem material to shareholder value.

The following are the E&S highlights of the 2017 proxy season:

Proposals calling for the disclosure of corporate political participation and/or lobbying policy/payments continue to be the issue most frequently brought to vote for the past few years. Proponents say disclosure enables shareholders to evaluate whether a company's lobbying is consistent with the company's expressed business goals and objectives and whether it may present any risks, particularly reputational risk. The Center for Political Accountability, for example, has been leading a campaign since 2003 for disclosure and accountability in corporate political spending, and shareholder engagement has been central to the organization's campaign. The 57 proposals that went to a vote in 2017 received average support of 25.8 percent of votes cast, up slightly from 2016 when the average support was 24 percent for the 67 proposals. While no proposals on this topic passed in 2017, two proposals received support of over 40 percent of for votes.

Proposals on this topic typically seek disclosure of payments to trade associations (such as the US Chamber of Commerce) used for lobbying as well as support for tax-exempt organizations that write and endorse model legislation (such as the American Legislative Exchange Council (ALEC)). For example, a shareholder proposal submitted at AT&T requested the company prepare a lobbying report.[1] Proponents of the proposal argued that AT&T's recognition of climate change as a serious concern is at odds with the company's position on the board of the Chamber of Commerce, which has publicly criticized the EPA's Clean Power Plan and efforts to address climate change.

Shareholder proposals asking companies to disclose the business risks related to climate change reached historically high levels of support. This year 18 proposals on climate risk disclosure were brought to a vote, up from 15 in 2016. These proposals have now reached historically high levels of support—average support of 39.2 percent of votes cast in 2017, up from 27.5 percent in 2016 and 16.7 percent in 2015. In fact, of the six proposals on environmental and social topics that passed this year, three of them called for climate risk disclosure. All three of these proposals were submitted at energy companies and all had a public pension fund as the main proponent. Notably, the New York State Common Retirement Fund was the most frequent sponsor of proposals on climate risk disclosure, sponsoring almost one-third of proposals on this topic.

Recent activity related to climate change risk disclosure is contributing to shareholders' increased interest in this topic. In 2010, for example, the U.S. Securities and Exchange Commission (SEC) published the Commission Guidance Regarding Disclosure Related to Climate Change, a document to help guide public companies on what climate change-related disclosures must be made. More recently, in April 2016, the international Financial Stability Board's Task Force on Climate Related Financial Disclosure (TCFD) sought public comment on its goal for creating disclosure recommendations to help companies practice "more methodical, comparable and consistent disclosure on climate-related risks and opportunities." In its June 2017 report the TCFD recommended that preparers of climate-related financial disclosures provide these disclosures in their mainstream financial filings.

Some of the largest passive investors, including BlackRock and Vanguard, are now looking at climate change as a major investment risk issue and are beginning to exert pressure on companies to disclose and manage their climate-related risks.[2] This pressure is having an impact: more than one quarter of S&P 500 companies now disclose climate change risks in their annual reports, up from only 5 percent just three years ago.[3] As evidenced by the historically high levels

[1] AT&T 2017 proxy statement, p.22, https://www.att.com/Investor/ATT_Annual/2016/downloads/notice_2017_annual_meeting_proxy.pdf

[2] "Financial firms lead shareholder rebellion against ExxonMobil climate change policies", The Washington Post, May 31, 2017, https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/

[3] Sustainability Practices Dashboard, The Conference Board, November 2016, http://www.conference-board.org/sustainabilitypractices

of support for proposals on climate change risk disclosure, shareholders are likely to continue to engage companies on this issue.

Shareholders are increasingly calling for companies to adopt policies and measures to enhance employee and board diversity. In 2017 shareholders voted on 14 proposals related to diversity issues, up considerably from the five proposals brought to a vote in 2016. Of the 14 proposals on diversity issues, eight proposals asked for the preparation of a report on the company's steps towards increasing board diversity (up from six in 2016). One of these proposals went beyond board diversity and asked for the company to work towards ensuring both board and senior management diversity. Two proposals on the topic of board diversity passed in 2017.

While the SEC introduced a board diversity disclosure requirement in 2009, the rule does little more than require companies to disclose how they consider board diversity. Critics point out that the current requirement does not define diversity nor does it offer investors sufficient and meaningful information on board diversity. The SEC, however, is working on a proposal to revise the existing diversity disclosure rule.[4] Revised disclosure requirements on board diversity may help shine more light on significant diversity imbalances among company boards. With respect to gender diversity, for example, women occupied less than 18 percent of Fortune 1000 corporate board seats in 2015. And while there has been progress, the current level of female representation is only a few percentage points higher than it was in 2011.[5]

Proposals related to employee diversity showed slight increases in both volume and support levels, going up from 4 proposals voted in 2016 to 6 voted in 2017. Support levels also increased from an average of 24.5 percent of *for* votes in 2016 to 26 percent of *for* votes in 2017.

A shareholder proposal on the topic of gender pay gap was first put on the proxy ballot of a US company in 2015, and since then the topic of gender pay gap has become one of the most frequently voted E&S topics during the proxy season. In 2017, 13 shareholder proposals were brought to a vote calling for companies to prepare gender pay gap reports. These proposals, the majority of which were sponsored by individuals, received average support of 12.1 percent of *for* votes. The volume of proposals on this topic was significantly up from 2016, when only five gender pay gap proposals were brought to a vote that entire year, receiving average support of 15 percent of *for* votes.

When the first shareholder proposal on this topic was brought to eBay in 2015 the proposal received a mere 7.4 percent of *for* votes. One year later, in 2016, support for the proposal at eBay surged to 44.6 percent of *for* votes. The significant increase in support for the proposal can be in part explained by a recommendation from proxy advisor Institutional Shareholder Services suggesting investors vote in favor of the gender pay gap proposal at eBay, stating that the resolution "is warranted, as eBay lags its peers in addressing gender pay disparity at its company."[6]

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[4] https://www.sec.gov/news/speech/chair-white-icgn-speech.html

[5] Every Other One: A Status Update on Women on Boards from the Committee for Economic Development, The Committee for Economic Development, November 2016, p. 5.

[6] "A surprising number of investors voted for a gender pay gap measure at eBay", The Washington Post, April 28, 2016, https://www.washingtonpost.com/news/on-leadership/wp/2016/04/28/a-surprising-number-ofinvestors-voted-for-a-gender-pay-gap-measure-at-ebay/?utm_term=.ccc279476bf5

Compared to last year, the number of proposals calling for companies to increase activity on the "Holy Land principles" rose considerably, making this one of the top five E&S topics of 2017 in terms of volume. In the January-June period, shareholders voted on 12 proposals related to the Holy Land principles, up from eight proposals in 2016. Support levels for these proposals remain very low, with average support of only 3.4 percent of votes cast.

Proposals on the Holy Land principles generally call for American companies conducting business in Palestine-Israel to practice fair employment. The Holy Land principles were launched by Father Sean McManus in 2012 and are based on the MacBride Principles, which Father McManus also launched in 1984.

Proposals asking companies to publish a sustainability report continue to gain support. These proposals call for companies to publish annual reports disclosing their various short term and long-term efforts related to environmental, social, and governance issues. In the first half of 2017 shareholders voted on 10 proposals on this topic, compared to 13 in all of 2016. Support for this topic reached historically high levels in 2017, with average support of 31.5 percent of *for* votes, up from 26.3 percent in 2016. In 2017 four proposals received over 30 percent of *for* votes, including one proposal that passed at Pioneer Natural Resources with 50.6 percent of votes.

* * *

The complete publication is available for download here. For details regarding how to obtain a copy of the report, please contact matteo.tonello@conference-board.org

Harvard Law School Forum on
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Doubling Down on Two-Degrees: The Rise in Support for Climate Risk Proposals

Posted by Cristina Banahan, ISS Corporate Solutions, on Tuesday, January 23, 2018

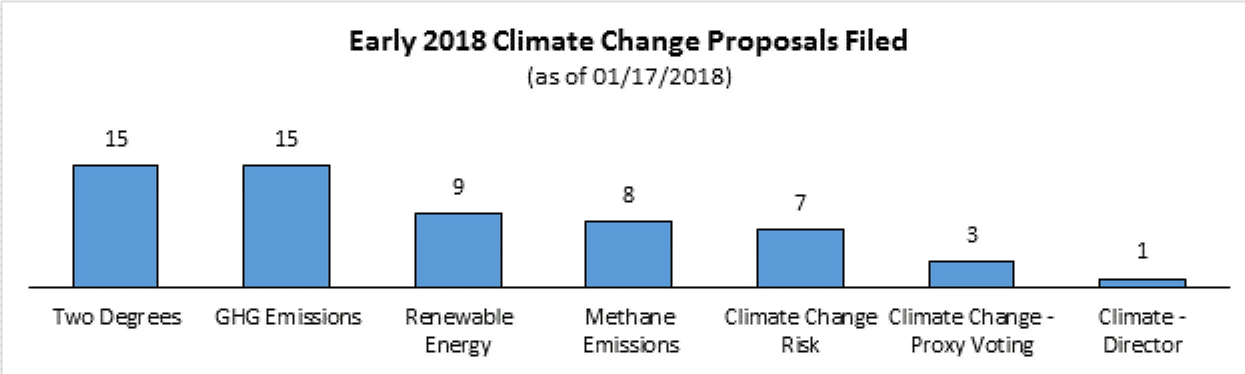
Editor's note: Cristina Banahan is an Advisor with ISS Corporate Solutions. This post is based on an publication by ISS, the parent company of ISS Corporate Solutions.

[Last week], BlackRock CEO Larry Fink released his annual letter to CEOs, an important signpost for investor priorities in the coming year. In his letter, titled "A Sense of Purpose," Mr. Fink says:

> "In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth.
>
> The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends—from slow wage growth to rising automation to *climate change* [emphasis added]—affect your potential for growth."

As investors such as BlackRock look deeper into strategy and climate change issues (and call them out specifically in their shareholder engagement activities), they are increasingly becoming more active in their support for calls for increased transparency and disclosure regarding portfolio companies' preparedness for climate change. And, when shareholder proposals are filed calling for increased transparency and disclosure, support rates are increasing.

In 2018, these types of proposals will likely feature even more prominently on the proxy landscape. ISS is aware of 59 filed proposals related to climate change for 2018 proxy season, including 15 two-degree scenario proposals (one already withdrawn—at Exxon Mobil) and seven proposals on climate change risk management. The two-degree scenario proposals were filed by ten different main filers (not counting any co-filers), which shows that these filings are not the result of a single campaign—as is often the case with environmental and social proposals—but the outcome of a widespread initiative.



Source: ISS Shareholder Proponent Database

Background of Two-Degree Proposals

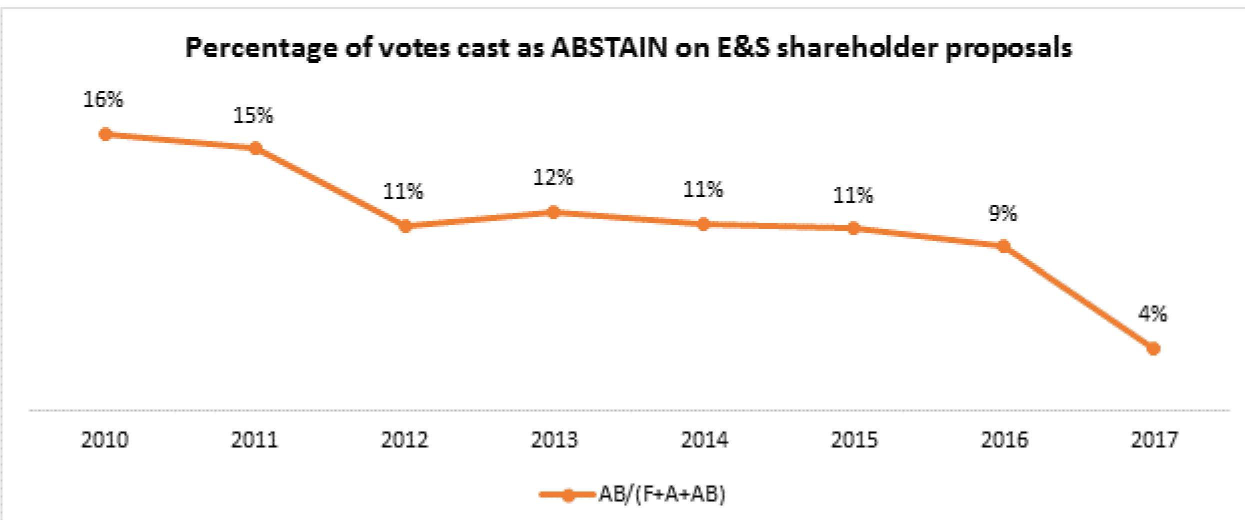
Two-degree scenario proposals are an evolution of shareholder requests for disclosure on how companies manage potential climate-related risks. Unlike former proposal types that sought for general disclosure on addressing climate change risks, the two-degree scenario proposals focus on two degrees Celsius above pre-industrial levels as the uppermost limit in global temperatures tolerable to the environment, as substantiated by the Intergovernmental Panel on Climate Change's scientific findings. In the United Nations Framework Convention on Climate Change's 2015 Paris Agreement, the international community pledged to adopt policies and programs to curb carbon emissions in order to reach the two-degree target. Shareholder proponents anticipate that, in order to meet the two-degree goal, governments will have to increase regulation, and the private sector will have to accelerate innovation. In particular, proponents seek disclosure on how companies are preparing for climate-related risks and how they account for these risks in their capital investment decisions. While shareholders argue that planning for a two-degree scenario is necessary for protecting the long-term value of their investments, corporate boards have broadly responded by saying that this risk analysis is conducted as part of the regular course of business. The financial risks, however, appear too high for shareholders to ignore; hence, proponents continued to push for greater disclosure.

Proponents of two-degree proposals include asset owners, SRI funds, foundations, and shareholder advocacy groups each with a long history of filing shareholder proposals. Notable filers include the New York State Common Retirement Fund, the As You Sow Foundation, Mercy Investment Services, Wespath Investment Management and many others. On some occasions, large asset owners like city and state pension funds brought forward proposals using the full weight of their shares. For example, in 2017, the New York State Common Retirement Fund owned 11.6 million shares valued at approximately $1 billion before bringing the two-degree proposal at ExxonMobil. On other occasions, proponents seeking additional disclosure were small asset owners with minor stakes in the company that barely met the minimum ownership requirement to file a proposal. It is common for multiple proponents to join forces and co-file proposals.

Changing Shareholder Attitudes

Marking a departure from previous trends, recent studies indicate that ESG and climate change considerations are gaining traction among investors. EY's 2017 investor survey on ESG issues found that investors routinely included ESG considerations as part of their investment decisions. Shareholders are not only paying closer attention to non-financial indicators, but they are also more likely to take action on such information. According to the study, the percentage of respondents who consider nonfinancial disclosures to be seldom material or have no financial impact dropped from 60% in 2013 to 16% in 2016. Furthermore, the report found that, when faced with disclosures of risk or history of poor environmental performance, 15 percent of investors responded that they would rule out the investment immediately, while 76 percent would reconsider the investment. Similarly, 8 percent of investors responded that they would rule out an investment with disclosures involving risk from climate change, while 71 percent would reconsider the investment.

Actual voting data seems to confirm the study; many shareholders are coming off the sidelines on environmental and social shareholder proposals. The trend of abstain votes has been downward over the past eight years, and took a sharp decrease in 2017.



Source: ISS Voting Analytics

Asset owners have pioneered efforts in climate change not only as filers of shareholder proposals but also as public advocates for risk management and transparency. Asset owners comprise the majority of the 409 signatories to the Global Investor Statement on Climate Change, representing more than $24 trillion in assets. Participating asset owners view climate change engagement as a part of their fiduciary duty to their beneficiaries. As signatories, they have committed to identifying low-carbon opportunities, assessing climate-related risk, and working with corporate issuers on disclosure practices. Some asset owners have gone further, identifying inaction on climate change as a failure to recognize the energy sector's vulnerability to an imminent paradigm shift. Moreover, a few public funds look at divestment from fossil fuel assets as the ultimate way of addressing climate risk concerns in their portfolio. New York City recently announced its decision to divest its pension funds of about $5 billion in fossil fuel investments, while New York State is reviewing a similar initiative upon the proposal of Governor Cuomo. The Norwegian government is also considering a recent proposal by its central bank to divest fossil fuel stocks from its $1 trillion sovereign wealth fund. Some in the asset owner community, including New York State Comptroller Thomas DiNapoli, argue that pension funds can achieve more on climate change through shareholder power in fossil fuel investments instead of divesting.

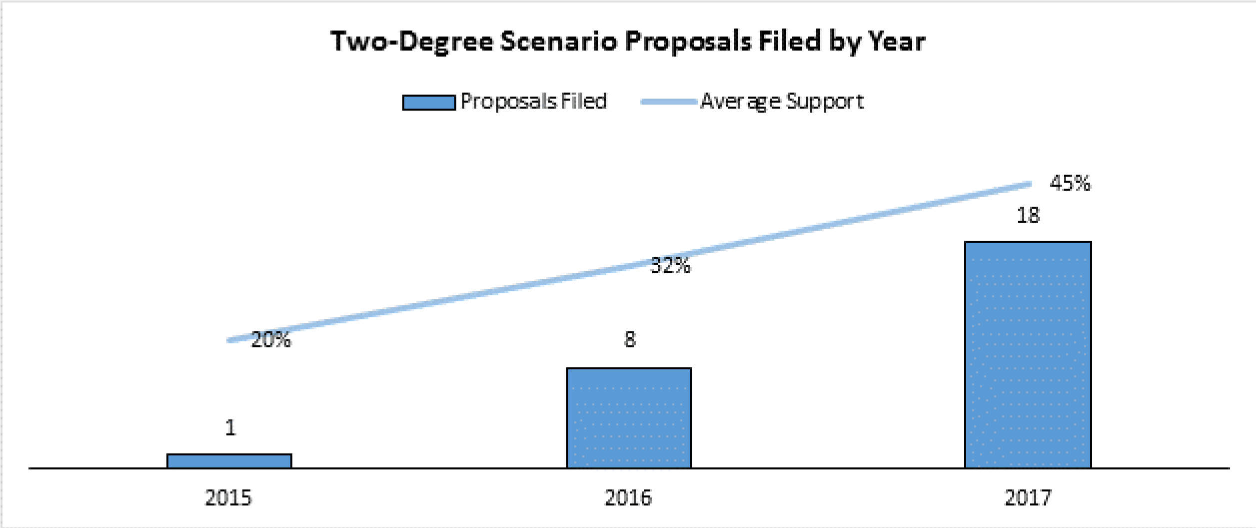
In the asset management community, we have seen an even more significant shift towards greater climate risk awareness in recent years. Asset managers' changes in attitude have emerged in the form policy updates and a closer look at sectors perceived to be particularly vulnerable. This trend becomes evident even among investors who were historically less supportive of environmental proposals. For example, in 2017, Fidelity Investments updated its proxy voting policy guidelines stating that, although it generally supports management on environmental proposals, it would consider supporting shareholders where the burden on the company would be low, and where disclosure would provide meaningful information. Specifically, Fidelity highlighted areas where it might support proposals to include disclosure on renewable energy and environmental impact. In turn, Blackrock, included climate risk disclosure as one of its main engagement priorities for 2017-2018: "Consistent disclosure of standards would enhance understanding of the impact of climate change on individual companies, sectors and investment strategies."

A change in policy does not suggest a monolithic approach to always supporting climate resolutions, since institutional shareholders generally apply a case-by-case approach. For example, institutions often vote differently at companies that appear to have similar climate risk profiles. Company-specific factors, such as current disclosure practices, overall performance, and future disclosure commitments may typically drive the voting decision. Improved company practice as a result of engagement may even lead to the withdrawal of proposals, as was the case with Chevron in 2017 in response to the company's release of its climate risk management report.

The success of two-degree proposals has been limited to the energy sector for the time being, while shareholder activists in other industries focus on different kinds climate change proposals. Two-degree proponents have been particularly interested in sectors perceived to be vulnerable to climate change regulation and renewable energy innovation, *i.e.*, utilities, oil and gas. However, proposals requesting general climate change action have extended beyond the energy sector to encompass finance, consumer goods, natural resources, technology, telecommunications, and healthcare. Climate change proposals for non-energy sectors mostly focus on setting GHG emissions goals, renewable energy targets, and changing proxy voting guidelines at asset managers. Excluding the energy sector, the next three industries to receive the most climate change proposals are the financial, consumer discretion, and consumer staples sectors.

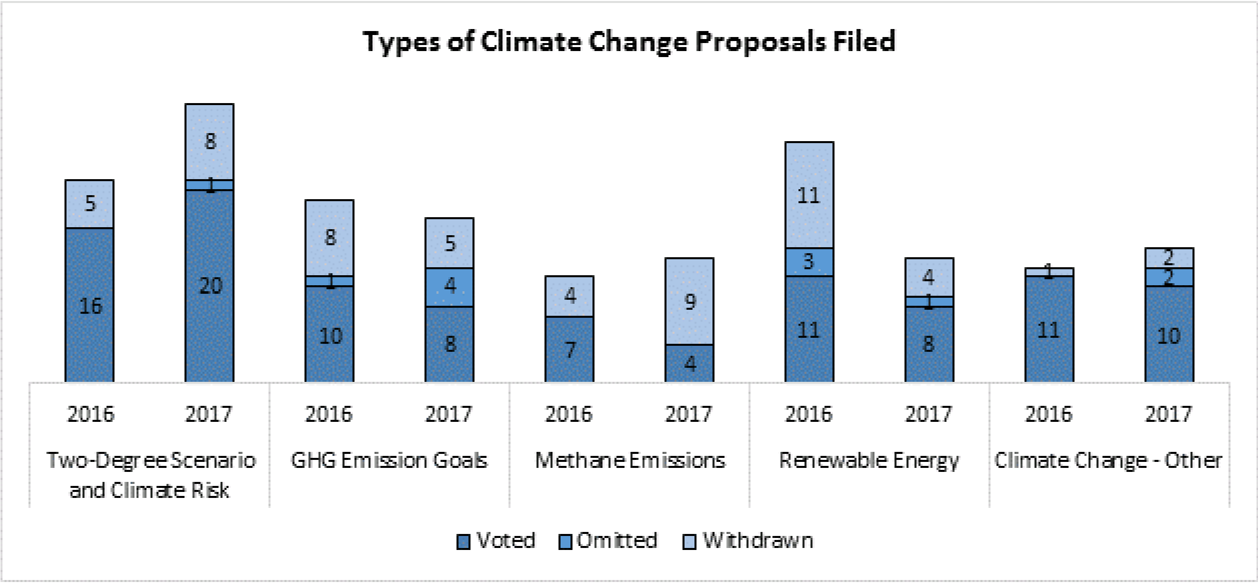
Two-degree proposals gaining momentum

The number of filings and support levels for two-degree proposals demonstrate the aforementioned shift in shareholder preferences. In 2015, there was a single two-degree proposal on ballot at Noble Energy, which received 20% support. In 2016, there were seven proposals, including those at Chevron, Exxon and Occidental Petroleum with support levels close to 40% of votes cast. The trend continued in 2017, as the number of filed proposals increased to eighteen, and average support levels exceeded 40% of the vote, with three proposals receiving majority support: ExxonMobil, Occidental Petroleum and PPL Corporation.



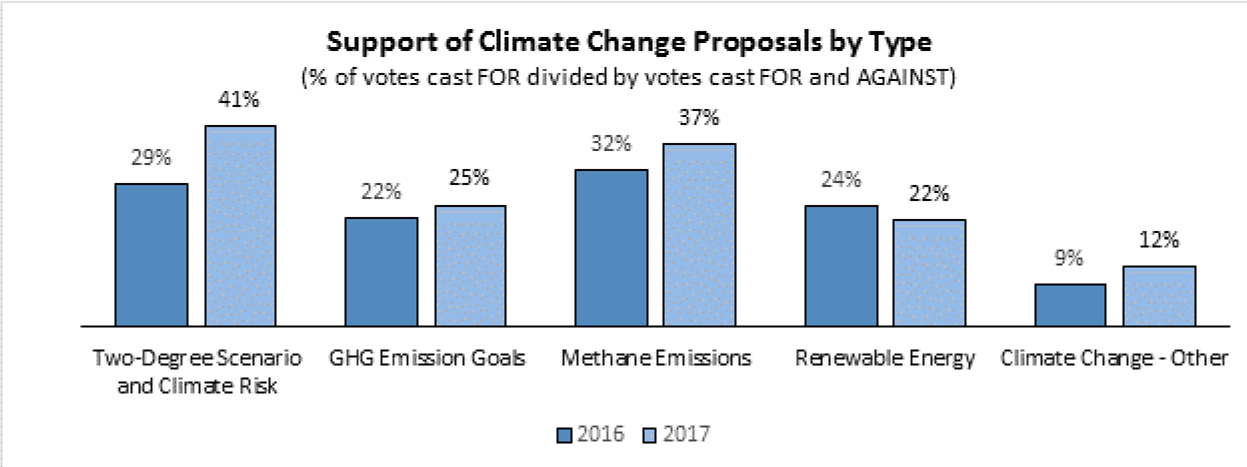
Source: ISS Voting Analytics

Two-degree and climate change risk proposals have outpaced the number of filings for all other climate change proposals. Proposals for greenhouse gas ("GHG") emission goals and renewable energy continue to be filed in large numbers. Other types of climate change proposals include: requests for review of proxy guidelines, nomination of directors with environmental experience, increase of return on capital in light climate change risks, among others.



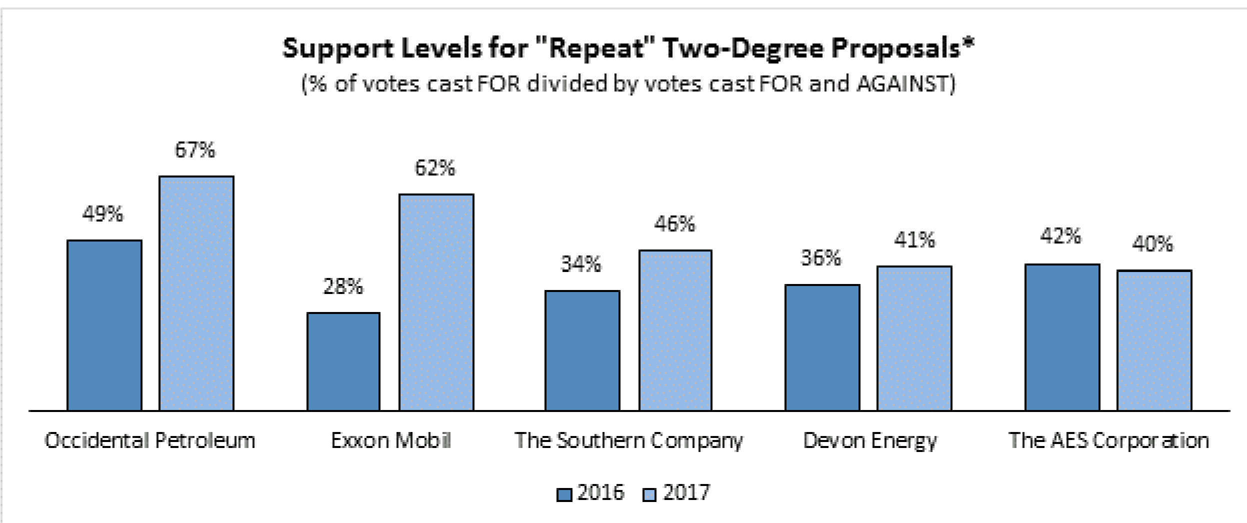
Source: ISS Voting Analytics

Two-degree and climate risk proposals not only outpaced other types of climate change proposals in the number of proposals filed, but also outpaced them in levels of support. Two-degree and climate risk proposals received almost twice the amount of support of the next two most frequently filed proposals—GHG Emission Goals and Renewable Energy. Although Methane Emissions also fared well in levels of support, the number of voted proposals in this category was limited.



Source: ISS Voting Analytics

While three climate risk proposals received majority support, several more fell just short. For instance, shareholder proposals at AES, FirstEnergy, Southern Company, Devon Energy, and Dominion Energy all received more than 40 percent support in 2017.



**Covers only companies that received proposals both years and the proposals went to a vote.*

Source: ISS Voting Analytics

The Path Ahead

Early indications are that the number of shareholder proposals on climate change issues will remain strong in 2018—perhaps even a record-breaking year. And with evolving voting policies at influential investors and some strong investor statements confirming a stronger dedication to climate change issues, it seems that those proposals will be met with increasing support at the ballot.

Through 2017, climate change risk proposals in the fossil fuel and utility sectors have received significant support, but proposals outside those sectors have not received the same energetic reception. 2018 may be the year where shareholder perceptions regarding the importance of climate change risk will extend outside the energy industry.

Perhaps the largest question remaining is: How open will companies be to negotiating climate change strategy, transparency and disclosure before the shareholder proposals reach the ballot? This could be the year where shareholder-initiated engagement efforts on climate change ramp up significantly; the number of filed and withdrawn proposals over proxy season 2018, and subsequent enhanced disclosures, may tell an interesting story.

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Looking Beyond Sustainability Disclosure

Posted by Linda-Eling Lee & Matt Moscardi, MSCI, Inc., on Wednesday, February 28, 2018

Editor's note: Linda-Eling Lee is Global Head of ESG Research at MSCI, and Matt Moscardi is Head of Financial Sector Research for MSCI ESG Research. This post is based on an MSCI publication by Ms. Lee and Mr. Moscardi.

For years, a growing number of institutional investors have pressured companies to disclose more of their ESG practices. Companies are responding, but voluntary disclosure has its limits in providing a full picture of companies' ESG risks. In 2018, we anticipate that the disclosure movement reaches a tipping point, as investors seek broader data sources that can balance the corporate narrative and yield better signals for understanding the ESG risk landscape actually faced by portfolio companies.

Companies historically have been caught between investor demands for transparency and a desire to control their corporate narrative. On one side, investors have supported numerous efforts to encourage company disclosure.[1] They have enlisted regulators to compel disclosure on select topics or metrics and influenced exchanges to require more disclosure on sustainability as part of their listing requirements.[2] On the other side, some companies may carefully manage disclosures through a painstaking editing and brand-polishing process[3] while protecting proprietary information.

As one of the world's largest consumers of voluntary sustainability disclosures,[4] MSCI ESG Research observes this pressure firsthand. What we see suggests corporate resistance is increasingly futile as investors globally are pressing hard for greater transparency around ESG and sustainability issues.[5] In response, companies are boosting the volume of voluntary disclosures and sustainability reports.

These public voluntary disclosures are a part of our ESG ratings research process. MSCI ESG Research shares with each company the data that we have collected from publicly disclosed documents.[6] Companies are invited to provide comments and feedback on the data in the

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[1] https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf shortlists the major disclosure frameworks on pages 4-5, including CDP, GRI, SASB, IIRC, and the FSB.

[2] See for example: http://www.sseinitiative.org; https://www.world-exchanges.org/home/docs/studies-reports/SE&SD-Report17.pdf; http://iri.hks.harvard.edu/files/iri/files/corporate_social_responsibility_disclosure_3-27-15.pdf

[3] https://www.theguardian.com/sustainable-business/2016/aug/20/greenwashing-environmentalism-lies-companies

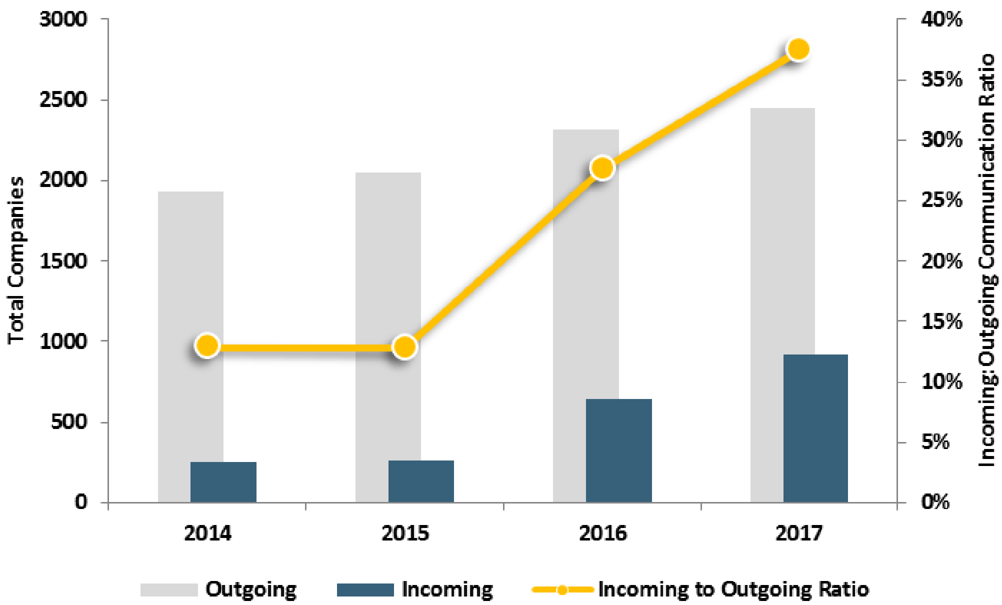
[4] https://www.msci.com/documents/1296102/1636401/MSCI_ESG_Research_Factsheet.pdf/411954d3-68af-44d6-b222-d89708c5120d

[5] https://corpgov.law.harvard.edu/2017/04/25/the-importance-of-nonfinancial-performance-to-investors

[6] MSCI ESG Research does not conduct surveys of companies, nor will it use or accept non-public information from companies or other sources. Any company disclosed information that is used in MS CIESG Research's ratings research process must be publicly disclosed. See https://www.msci.com/for-corporate-issuers. MSCI ESG Research

reports. We have observed a dramatic increase in the volume of “inbound” communications from issuers asking about their ESG assessments, while the volume of our “outbound” communications (invitations to review their data) has stayed relatively level. Between January 1, 2014 and November 30, 2017, the ratio of incoming company queries to outgoing company communications nearly tripled for MSCI ACWI Index constituents, a statistic we take as a sign that companies are paying increased attention to how they are assessed.

Volume of Communications With Issuers by Year, Outgoing vs. Incoming



Source: MSCI ACWI Index constituents as of November 30, 2017. MSCI ESG Research, 2017

Investors should be encouraged by companies’ increased willingness to invest in providing more transparency around ESG issues. At the same time, it is important to note that company disclosure provides only a partial understanding of a company’s underlying risks. Take the Wells Fargo customer account scandal as an example. At the beginning of 2016, Wells Fargo’s cross-selling prowess, for which the company has reported metrics such as percentage of customers with multiple Wells Fargo accounts,[7] was the envy of other banks.[8] By the end of the year, other members of the banking industry were questioning the practice and scrutinizing their own cross-selling policies.[9]

In fact, even relying on audited, regulator-mandated financial data can provide an imperfect picture. In 2016 alone, 22% of all U.S.-listed companies issued “non-material” restatements on their regulatory filings and 7%, or 669 companies, issued a material restatement; both statistics

invites all corporate issuers at least once per year to engage in a standardized data review process through which issuers may review the ESG data that we have collected on their company to produce various MSCI ESG Research reports, including the MSCI ESG Ratings report.

[7] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2014/consumer-lending-presentation.pdf

[8] https://www.forbes.com/sites/halahtouryalai/2012/01/25/the-art-of-the-cross-sell/#72023b1a55a3

[9] https://www.apnews.com/7007a4cd928240679a0c7cd359d1607b

were actually six-year *lows*.[10] Whether disclosure is voluntary or mandatory, it may not provide a full picture of a company's practices or reveal obvious lapses in internal controls.

The fact that companies tend to put their best foot forward may not be lost on investors. A 2017 PwC survey of U.S. investors found that 62% felt they don't "have enough trust in the information companies report" to be confident in investment analysis and decisions.[11]

What this suggests is that an objective signal of a company's ESG risks cannot primarily be driven by an issuer's own corporate narrative, particularly when much of that narrative is purely voluntary and not subject to regulatory (or even auditor) oversight. We find that additional information sources are crucial to balance self-disclosed information. In the era of big data, the opportunity exists to extract more data from a wider variety of publicly available sources that can provide a more accurate and complete picture of companies' ESG risks and performance.

To illustrate how important these additional data sources are to ESG assessments, relative to the contribution of voluntary company ESG disclosure, we decompose the contribution to our ESG ratings by sources of information. We separated sources of information into:

- **Voluntary company ESG disclosure**, which includes data from sustainability reports and corporate websites covering all MSCI ACWI Index constituents where available
- **Mandatory company disclosure**, such as financial filings and proxy statements, covering over 28,000 companies globally
- **Enforcements and media sources**, such as databases on government fines, violations and investigations, as well as 1,600+ local and global media outlets
- **Datasets on specialized topics from government, academic, NGO and commercial sources** such as those provided by the World Bank; Eurostat; International Labor Organization; Water Resources Institute; the Lamont-Doherty Earth Observatory; UK Reporting of Injuries, Diseases and Dangerous Occurrences Regulations (RIDDOR); International Chemical Secretariat (ChemSec); US Bureau of Labor Statistics; and others, covering more than 100 specialized datasets.

Different sources of information contribute to different scoring components of the ESG Rating. For example, mandatory disclosure is the predominant information source underlying the sub-model for assessing corporate governance practices.[12] We examined a sample of our coverage universe, the 2,434 constituents of the MSCI ACWI Index, as of November 30, 2017.

What we found helps illustrate both the value and potential limits of voluntary disclosure in our ESG signal. Fully 35% of any given company ESG rating, on average, is composed of scores that rely on what a company has disclosed through voluntary sources, while the other 65% is composed of scores using data from specialized data sources, enforcement and media sources,

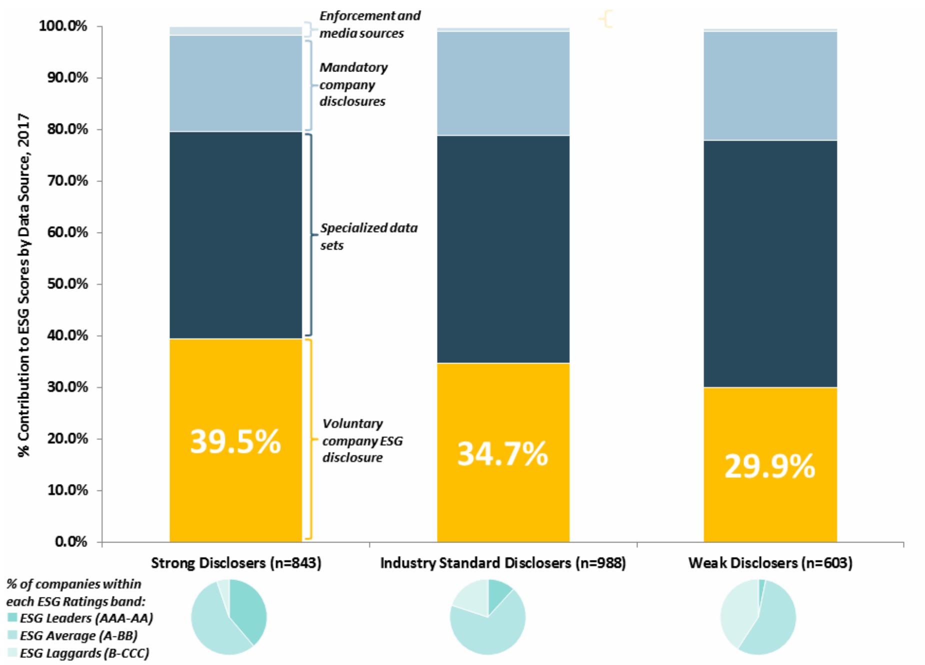
[10] https://blogs.wsj.com/cfo/2017/06/07/financial-restatements-hit-six-year-low; http://www.auditanalytics.com/blog/2016-financial-restatements-review

[11] https://www.pwc.com/gx/en/corporate-reporting/assets/cr-survey-us-final.pdf

[12] Other important sub-models that drive the overall ESG Rating include the risk exposure model which relies predominantly on specialized data sources, and the risk management model which relies predominantly on voluntary corporate ESG disclosure.

and mandatory disclosure.[13] For companies that are "strong disclosers,"[14] 39.5% of their ESG Ratings came from scores that rely on voluntary ESG disclosure. This compares to 27.4% for the "weak disclosers." Because voluntary ESG disclosure does not drive the majority of the ESG Rating, "strong disclosers" are not automatically highly rated, and "weak disclosers" are not automatically lowly rated. In fact, 5% of "strong disclosers" got a rating of B or lower (considered "ESG Laggards," as ratings range from AAA to CCC), and conversely, almost 60% of "weak disclosers" got a rating of average or above. The implication here is pretty simple: more voluntary disclosure may contribute more to the ESG rating, but may only result in improved ratings up to a point.

Voluntary Company Disclosure is a Significant, But Not Predominant, Contributor to ESG Ratings



2,434 constituents of the MSCI ACWI Index as of November 30, 2017. Source: MSCI ESG Research.

[13] A company's ESG Rating is driven by major its management practices and performance vis-à-vis the level of industry-specific ESG risks the company faces (risk exposure) and, its corporate governance practices. To assess the first input to the signal i.e. whether the company has requisite management, the model relies heavily on voluntary ESG disclosures. Higher level of relevant company's voluntary disclosures on its practices and performance informs the model better, relying less on other three sources. The second input to the model i.e. risk exposure is informed by our modeled non-company datasets while the last input to the model, corporate governance practices is researched based on the mandatory company disclosures. To understand the how much our model signals are driven by availability of these sources.

[14] The MSCI ESG Rating model does not "score" companies on the volume of disclosure they make, nor do we make this data public as it is used for largely internal purposes. Solely for this analysis, we have categorized companies based on a qualitative assessment of companies' disclosure practices, as follows: Strong disclosers: Company reports on extensive list of KPIs found in CSR report and/or integrated with other disclosures and/or on its website; Industry standard disclosers: Company provides general statements, few datapoints/KPIs covered in CSR report, integrated with other disclosures, and/or on its website; Weak disclosers: Company provides only non-ESG specific information on career websites, investors relations page, financial or regulatory disclosure.

While investors will, and should, continue to demand greater corporate transparency, they also need objective signals that don’t overly rely on what companies say they do. As campaigns for improvements in disclosure ramp up this year, we may find that we hit a turning point in how investors view such disclosures. The availability of big data will likely increase and play a crucial role in balancing the corporate narrative to produce a more powerful ESG signal.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

SUPPORTED BY: pwc

ISS QualityScore: Environmental and Social Metrics

Posted by Ning Chiu, Davis Polk & Wardwell LLP, on Tuesday, February 20, 2018

Editor's note: Ning Chiu is counsel at Davis Polk & Wardwell LLP. This post is based on a Davis Polk publication by Ms. Chiu.

Along with its four pillars for governance which score companies on a one to ten scale, ISS has launched Environmental & Social (E&S) QualityScore to measure corporate disclosure on environmental and social issues. Similar to the Governance QualityScore, the measures are relative based on peer companies within a specific industry group.

An initial set of 1,500 companies is being covered globally, including Energy, Materials, Capital Goods, Transportation, Automobiles & Components, and Consumer Durables & Apparel. It is expected that by Q2 2018, an additional 3,500 companies across 18 industries will be included. The scores will be part of the companies' proxy voting reports, but like all of the QualityScores, will not impact the vote recommendations.

More than 380 E&S factors, of which at least 240 apply to each industry group, will be assessed. Broad topics for the environmental disclosure include: (a) Management of Environmental Risks and Opportunities; (b) Carbon and Climate; (c) Natural Resources; and (d) Waste and Toxicity. There are 12 subcategories below this level. Social-related disclosures evaluated include: (a) Human Rights; (b) Labor, Health, and Safety; (c) Stakeholder and Society; and (d) Product Safety, Quality, and Brand. There are 25 subcategories in total.

The Key Issues document outlines for each subcategory the factors examined. For example, the category Carbon and Climate has a subcategory on Energy and Fuel Efficiency that checks whether companies have disclosed 11 metrics, including total energy use and energy derived from renewable and non-renewable sources. The category Labor, Health and Safety has a subcategory on Compensation and Benefits that looks at whether a company has made a commitment to a fair or living wage and responses to living wage controversies.

According to the ISS FAQ, the scores measure company disclosure. Unlike some of the other ESG "raters," ISS does not include assessments of corporate practices based on outside reports. ISS notes that investors report that company disclosure "is a meaningful signal in its own right."

Data is collected from company filings, sustainability and CSR reports, publicly available company policies and information on corporate websites. An additional measure is company participation in "multi-stakeholder initiatives," which are collected from those stakeholders' websites or member lists. Some of the company participation that is scored include participation in the UN Global Compact, the Global Network Initiative and the Voluntary Principles on Security and Human Rights.

The expectations for the disclosure are defined by industry and certain standard-setters that include the Global Reporting Initiative (GRI), the Sustainability Accounting Standard Board (SASB) and the Task Force on Climate-related Financial Disclosures (TCFD). ISS stated that these standards were used in both selecting the factors and the weighting of those questions relative to the overall score, meaning that the factors related to these standards are more heavily weighed than other factors.

ISS indicated that the data could be updated daily. Like the Governance QualityScore, issuers can verify their data, and make submissions of corrected or updated data factors, through the ISS data verification site.

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Key Trends in Corporate Incidents

Posted by Doug Morrow and Martin Vezér, Sustainalytics, on Saturday, February 24, 2018

Editor's note: Doug Morrow is Director and Martin Vezér is Senior Associate of Thematic Research at Sustainalytics. This post is based on recently published reports by Mr. Morrow, Dr. Vezér and their colleagues Andrei Apostol, Kasey Vosburg, Rita Ferreira and Will Meister.

Corporate activities that generate undesirable social or environmental effects are a valuable source of information for investors. Environmental, social and governance (ESG) incidents can reflect gaps in a company's management systems, vulnerabilities in corporate strategy and lapses in policy development, all of which are relevant to company analysis and evaluation. If policies and programmes are the talk of corporate ESG management, then incidents are the walk.

Incidents can also have direct financial effects. Many well-known examples of shareholder value destruction over the last few years, including product safety concerns at Samsung, the Dakota Access Pipeline controversy and the Volkswagen emissions scandal, constituent incidents.

Focusing on the essential trends and applications

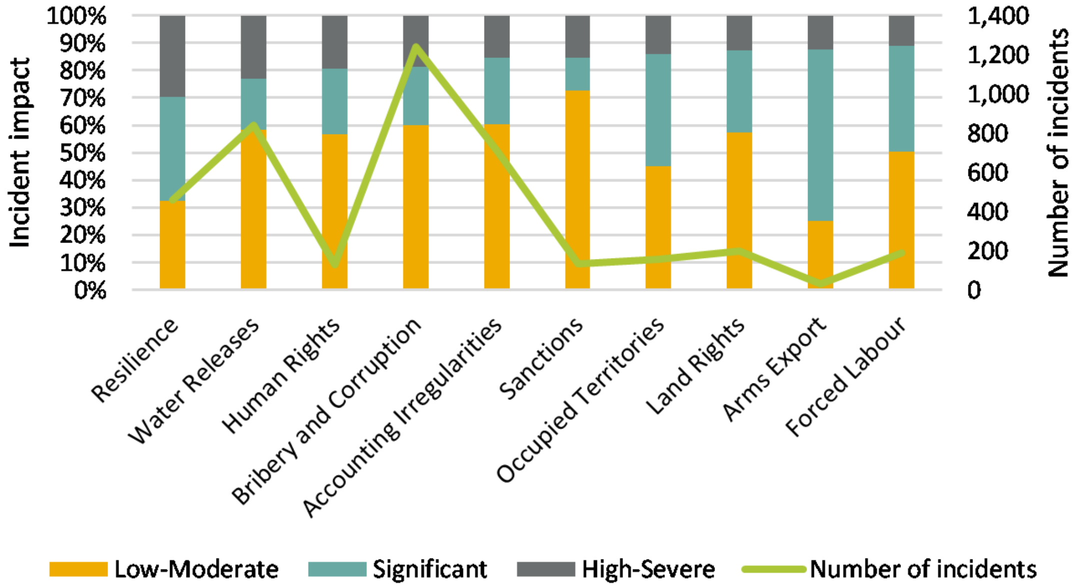
In our recently published study, *Understanding ESG incidents: key lessons for investors*, we analyze 29,000 incidents that took place in 176 countries from 2014-2016. We identify the essential incident trends, including those related to company size, industry classifications, geographical considerations and financial effects.

Two incident types run against the grain

Our analysis reveals that low-impact incidents are common, and high-impact incidents are rare. Low- and moderate-impact incidents together account for more than three-quarters (78%) of all incidents. The remainder are categorized as significant (16% or 4,557 incidents), high (6% or 1,638 incidents) and severe (1% or 290 incidents).

As indicated by the figure below, however, two incident types—Bribery and Corruption and Water Releases—run against the grain: they are relatively common and often highly impactful.

Incident types with the largest proportion of cases ranked high-severe



Source: Sustainalytics

In our new report, *10 for 2018: ESG risks on the horizon,* we take a closer look at these two incident types and focus on two of the most exposed industries: Diversified Chemicals and Aerospace & Defense.

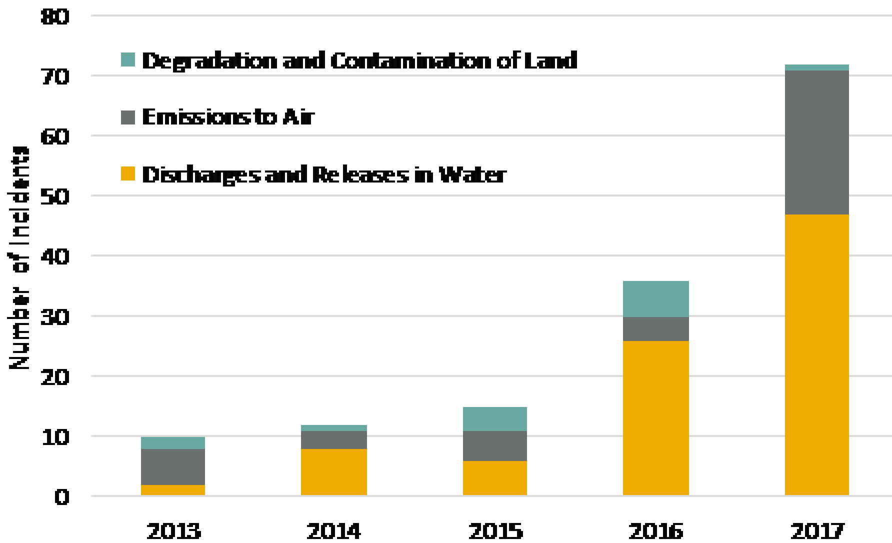
Hazardous water releases in the diversified chemicals industry

The diversified chemicals industry is facing intensifying risks related to the ecological, social and human health effects of releasing hazardous chemicals into the environment. While hazardous chemical releases have been a long-standing problem in the industry, the associated financial consequences of such incidents are on course to catch up with involved firms. Exposed companies face increasing scrutiny from the public, the media, and regulators in key markets, including North America and Europe. A recent series of multimillion dollar lawsuits and government investigations could be a harbinger of shareholder value destruction on the horizon.

Companies responsible for hazardous chemical releases face direct legal and clean-up expenses and substantial reputational blowback. In February 2017, for example, DuPont (now DowDuPont) and Chemours agreed to a USD 671mn settlement involving more than 3,500 lawsuits brought by residents of Ohio and West Virginia after it was revealed that a chemical (PFOA/C8, used in Teflon production) that DuPont released into local water supplies was linked to several diseases, including cancer.

These are not isolated cases. Our analysis finds that between 2013 and 2017, 33 diversified chemicals firms were linked to 145 incidents involving emissions, effluents and waste in 15 countries around the world. As shown in the figure below, our research has been capturing a growing number of such incidents.

Diversified chemicals incidents involving emissions, effluents and waste



Source: Sustainalytics

Bribery and corruption

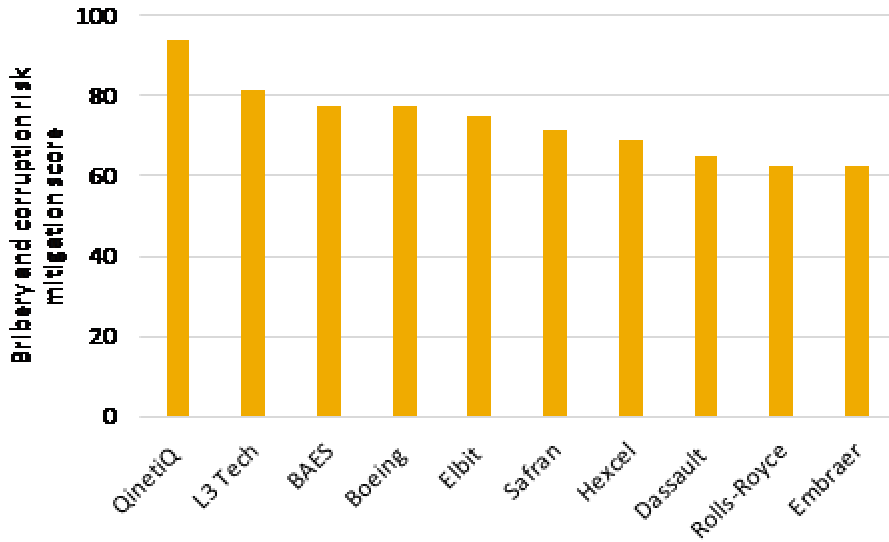
The aerospace & defense (A&D) industry continues to face elevated risks associated with anti-corruption initiatives launched by governments. Enforcement agencies are increasingly targeting firms under anti-corruption legislation, such as the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act.

To settle bribery and corruption allegations pursued by US enforcement agencies, a sample of just five global A&D companies have had to face penalties reaching USD 855mn in recent years.

Zeroing in on 10 high-profile firms, the figure below shows the range of performance of companies we assess. Despite having relevant programmes, Embraer sits at the low end with a score of 63, reflecting its recent track record. Comparing the performance of Embraer, BAES and Boeing provides further context about the market. Although the USD 400mn fine that BAES incurred in 2010 was nearly twice as large as the figure cited in the cases against Embraer, Embraer's 2016 settlement is more recent and, as we detail in the report, the controversy is persistent.

Embraer's underperformance relative to Boeing is noteworthy because the two firms are currently working on a deal that could result in Boeing acquiring Embraer.

Bribery and corruption risk mitigation performance of 10 high-profile A&D firms



Source: Sustainalytics

Research on the horizon

Our case studies focusing on diversified chemical releases of hazardous materials in water supplies and bribery and corruption in the A&D industry are only two examples that illustrate how corporate law plays an important role in ESG incidents research. Other relevant examples that we examine include antitrust regulatory actions facing technology firms in Europe, litigation facing sugary drink producers in the US and public scrutiny of the supply chain management practices of apparel retailers with operations in Asia and Africa.

We will continue to analyze the growing Sustainalytics incidents universe, monitor the market and experiment with applications of our key findings. We anticipate that further developments in the legal and regulatory environment will continue to influence corporate activities and investment decisions moving forward.

The complete publication, including footnotes, is available here.

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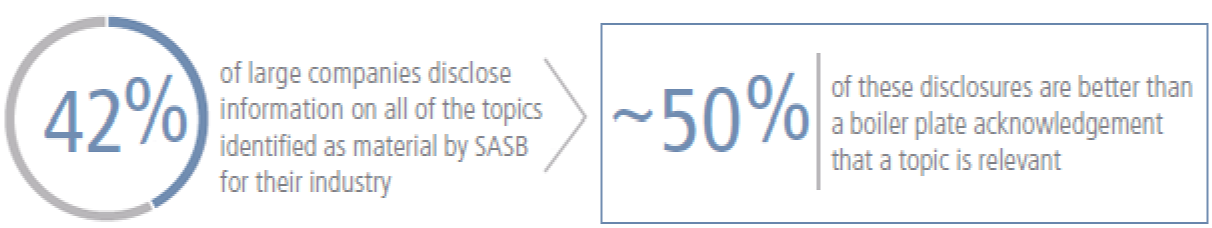
From Talking the Talk to Voting the Votes

Posted by Jonathan Bailey and Jake Walko, Neuberger Berman Group LLC, on Tuesday, January 30, 2018

Editor's note: Jonathan Bailey is Head of ESG Investing and Jake Walko is Vice President of ESG Investing at Neuberger Berman Group LLC. This post is based on a Neuberger Berman publication by Mr. Bailey and Mr. Walko.

Management teams at companies often say that they wished they had more clarity from their investors as to the types of sustainability data and disclosures that they would like to see. They believe that it is difficult to understand which, if any, of the many different surveys and questionnaires that they get from data providers, research companies, and non-profit organizations are actually used by investors in valuing a company and making a buy decision. That is why the Sustainability Accounting Standards Board's (SASB) development of a market-based, investor-ready set of material sustainability disclosures is so important. Many of the world's leading asset owners and asset managers were among the 2,800+ participants in SASB's industry working groups that helped develop the standards, and many of those same investment firms have voiced their support for their implementation by companies.

Yet despite the vocal support by investors, the state of disclosure by companies is still lacking—only 42% of large companies disclose information on all of the topics identified as material by SASB for their industry, and only about half of these disclosures are better than a boiler plate acknowledgement that a topic is relevant.[1] To encourage companies to elevate their disclosure levels, investors need to do more than be vocal—they need to start systematically embedding SASB in their processes and policies. In Neuberger Berman's case, we decided that in addition to proactively and reactively talking to companies about why SASB standards are material and useful, we would integrate SASB into our Proxy Voting Guidelines. Our Proxy Voting Guidelines for the 2018 season include an expectation that directors be familiar with the SASB standard for their industry and be able to discuss how SASB's topics and metrics relate to the risk assessment for their business.



[1] Sustainability Accounting Standards Board. *State of Disclosure Report—2017—Excerpt*, 2017.

We understand that stakeholders within companies often push-back on increasing sustainability disclosures because of perceived costs or risks. By incorporating SASB as a cost-effective solution into our Proxy Voting Guidelines, we can reach a wide set of these stakeholders—corporate secretaries, board members, CFOs and investor relations professionals—many of whom may not have historically engaged in discussions about sustainability reports or disclosures, or may not be aware of the sustainability frameworks that investors think are most relevant. We also know that the proxy voting advisory firms, and even the SEC, use guidelines published by asset managers and asset owners to help determine how investor perceptions of materiality are evolving.

Of course, proxy voting guidelines are intended not just to frame the discussion but also to drive voting behaviors, and so Neuberger Berman will be using the SASB industry research to help determine whether sustainability-focused shareholder proposals are material (see "Neuberger Berman Proxy Voting Policy—Guidelines"). In 2017, we used the SASB standards in our decision to support shareholder proposals requesting reports or action on climate change at 15 companies because we viewed climate change to be a material business issue for companies in the utilities and oil & gas sectors. We also used the framework in deciding to support shareholder proposals calling for gender pay equity reports at seven companies because we consider developing and rewarding a diverse talent pool to be a material business issue for companies in the financial services and technology sectors.

We believe SASB fills a critical gap in the current market infrastructure and as such serves as an important public good. It is therefore our view that it is incumbent on asset managers and asset owners to support SASB's work by providing comment and input on the standards themselves, encouraging implementation of the standards among companies, integrating the standards into security selection and portfolio construction, and directly supporting SASB's operations through the SASB Alliance. By working together we can raise the quality of sustainability disclosure, which help us identify the sustainable businesses that we believe will generate positive investment returns for our clients over the long run. This ultimately rewards sustainable businesses by reducing their cost of capital while building a more prosperous and resilient global economy.

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SUPPORTED BY: pwc

Analysis of SEC Ruling on Apple Shareholder Proposal

Posted by Arthur H. Kohn, Sandra Flow, and Mary E. Alcock, Cleary Gottlieb Steen & Hamilton LLP, on Tuesday, January 9, 2018

Editor's note: Arthur H. Kohn and Sandra Flow are partners, and Mary E. Alcock is counsel at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb publication by Mr. Kohn, Ms. Flow, Ms. Alcock, and Elizabeth K. Bieber. Related research from the Program on Corporate Governance includes Social Responsibility Resolutions by Scott Hirst (discussed on the Forum here).

On November 1 2017, the Securities and Exchange Commission ("SEC") released guidance (Staff Legal Bulletin No. 14I ("SLB 14I")) clarifying the scope and application of the ordinary business and economic relevance grounds for excluding a shareholder proposal under Rule 14a-8 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") from a company's proxy statement.[1] On November 20, Apple Inc. became the first corporation to attempt to use this guidance in a request for no-action relief from the staff of the SEC's Division of Corporation Finance (the "Staff"), in response to governance activist Jing Zhou's proposal that Apple create a board committee focused on human rights (the "Proposal"). On December 21, 2017, the Staff responded, denying Apple's request to exclude the Proposal from its proxy materials.

In seeking no-action relief, Apple specifically relied on SLB 14I, which Apple characterized as "new staff policy regarding the application of [the ordinary business exclusion that] the Company believes supports the Company's exclusion of the proposal." Since Apple's application was filed after the 80-day deadline for a no-action relief request, Apple argued both that the release of SLB 14I was good cause for a waiver of the timing requirement and that the policy announced in it provided a substantive basis for exclusion. The Staff denied Apple's request, commenting specifically on the application of the ordinary business exclusion (the Staff's reply does not specifically address the timing issue). The Staff's reply clearly indicates that the guidance in SLB 14I should not be construed as providing an automatic pass for companies whose boards of directors can be shown to have deliberated on the issues raised by a particular shareholder proposal. That posture is consistent with informal statements by members of the Staff since the release of SLB 14I, and should give governance advocates some comfort that SLB 14I will not be applied as broadly as some have speculated.

In its request, Apple argued that issues related to human rights are fundamental to its business operations and therefore should be excludible under the ordinary business exception of Rule 14a-8(i)(7) under the Exchange Act. Apple explained that human rights concerns are integrated into its business, citing supplier compliance initiatives, prominence on its website, action that goes beyond relevant minimum standards set by the laws in various jurisdictions in which it operates and its dedication of resources to the issues. The request detailed various ways in which human

[1] See our prior Alert Memo, discussed on the Forum here.

rights concerns factor into the company's operations, and went so far as to state that "the observance of human rights standards factors into *every decision* made by management in the day-to-day operations of the Company." (emphasis added)

In light of SLB 14I's focus on board process,[2] Apple's no-action request also contained significant details regarding its Board process. It stated that the Board specifically considered and deliberated about the Proposal.

The challenge for Apple was to show that while the topic of human rights was integral to ordinary business operations, it did not raise a "significant policy issue" that transcends the Company's ordinary business. Apple argued, unsuccessfully, that because it already had significant oversight in place concerning human rights issues, the Proposal was "redundant" and therefore not a "significant policy issue." The Staff used language from Apple's no-action letter in citing its reasons for denial, finding that Apple's argument that human rights issues are an "integral component of the [company's] business operations" tended to provide more support for inclusion of the shareholder proposal. The SEC also cited a lack of analysis, including at the board level, that explained why the proposal would not "raise a significant issue for the [company]."

Notably, Apple did not make an argument for exclusion based on economic relevance. Rule 14a-8(i)(5) under the Exchange Act permits companies to exclude a proposal that "relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business." The discussion in SLB 14I raised the possibility that companies would argue that proposals related to environmental, social and governance ("ESG") issues do not meet the economic relevance standard. The Apple request highlights a further difficulty that companies may face in taking advantage of the new SLB 14I guidance: under what circumstances, if any, could a company argue on the one hand that ESG issues are ordinary course and permeate operational decisions so that they should be excludible under the ordinary business exclusion, and also argue on the other hand that they are not "economically relevant"—i.e., that they are not related to substantial business operations?

While the Staff was not persuaded by Apple's arguments, it remains to be seen whether and how a similar argument could be presented to take advantage of the apparent opportunity afforded to SLB 14I's discussion of board process. That is, how does a company show that an issue is ordinary course and without significant policy implications, but also that it was important enough for the board to have considered it in a way that evidences that conclusion? Could a company argue, for example, that an ESG or other issue is operationally important, but the board never

[2] SLB 14I states that "at issue in many Rule 14a-8(i)(7) no-action requests is whether a proposal that addresses ordinary business matters nonetheless focuses on a policy issue that is sufficiently significant. These determinations often raise difficult judgment calls that the Division believes are in the first instance matters that the board of directors is generally in a better position to determine. A board of directors, acting as steward with fiduciary duties to a company's shareholders, generally has significant duties of loyalty and care in overseeing management and the strategic direction of the company. A board acting in this capacity and with the knowledge of the company's business and the implications for a particular proposal on that company's business is well situated to analyze, determine and explain whether a particular issue is sufficiently significant because the matter transcends ordinary business and would be appropriate for a shareholder vote. Accordingly, going forward, we would expect a company's no-action request to include a discussion that reflects the board's analysis of the particular policy issue raised and its significance. That explanation would be most helpful if it detailed the specific processes employed by the board to ensure that its conclusions are well-informed and well-reasoned. We believe that a well-developed discussion of the board's analysis of these matters will greatly assist the staff with its review of no-action requests under Rule 14a-8(i)(7)."

had reason to consider it (because it raises no significant policy issues) until the company received a shareholder resolution about it?

In sum, many commentators initially assumed that SLB 14I signaled a new willingness by the Staff to defer to companies in regard to shareholder proposals, in line with the new administration's overall regulatory attitude. While it is not yet clear that this view should be adjusted, the Staff's response to the Apple request indicates that the citation of board process and an involvement of the board in an assessment of a shareholder proposal will not give rise to an automatic pass with the Staff. We continue to believe that companies should carefully consider the role that boards should play in the Rule 14a-8 process in light of SLB 14I.

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Shareholder Proposals in an Era of Reform

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Thursday, November 30, 2017

Editor's note: David A. Katz is partner and Laura A. McIntosh is consulting attorney at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication by Mr. Katz and Ms. McIntosh which originally appeared in the *New York Law Journal*.

Securities and Exchange Commission Chair Jay Clayton has emphasized that corporate governance rulemaking under his leadership will be designed to maximize the long-term interests of the retail shareholder. On several occasions over the past year, Chairman Clayton has indicated that the shareholder proposal process is in need of reform, as it is an area in which the SEC can reduce the costs currently borne by—in Chairman Clayton's terms—"the quiet shareholder, the ordinary shareholder" on behalf of the "idiosyncratic interests" of a louder few. New SEC guidance released this month begins this process by elevating the role of boards in evaluating shareholder proposals for exclusion under Rule 14a-8. Staff Legal Bulletin 14I represents a meaningful change in the way certain shareholder proposals are addressed by boards of directors and reviewed by the SEC staff, with the potential for significant improvement in both process and results. SLB 14I should be a valuable tool for companies to minimize unnecessary costs of the shareholder proposal process while still ensuring that a worthwhile proposals will be presented for shareholder consideration. While further reform of the 14a-8 regime is necessary, SLB 14I is an important development in the right direction.

The Need for Reform

This summer, the Chamber of Commerce's Center for Capital Markets Competitiveness urged reform of the current shareholder proposal process, characterizing the status quo as "yet another burden on companies and their shareholders that only serves to make the public company model less attractive." The Chamber observed that the shareholder proposal system's protections for ordinary shareholders have weakened over time, with the result that the process "has unnecessarily devolved into a mechanism that a minority of interests use to advance idiosyncratic agendas that come at the expense of other shareholders." Recent data support this view. According to a Manhattan Institute report, half of all shareholder proposals submitted in 2016 addressed a social or policy-related matter, rather than a topic relevant to the long-term performance of the company. The same report found that six individual investors were responsible for one-third of all shareholder proposals in 2016, and 38 percent of the proposals were sponsored by institutional investors with an explicit social, religious, or policy agenda. In other words, the shareholder proposal process has been a costly tool used by few with little-to-no benefit for the majority of investors.

Both the Business Roundtable and the Chamber of Commerce have advocated for changes to the no-action process for excluding 14a-8 shareholder proposals. They cite a lack of clarity and consistency in the criteria for exclusion, and they criticize the narrowness of currently available grounds for exclusion. Both organizations call for the reversal of Staff Legal Bulletin 14H, which followed the SEC's controversial *Whole Foods* no-action decision in 2015 and dramatically limited the exclusion available for shareholder proposals that are in "direct conflict" with company proposals. The Business Roundtable's statement pointed out that this decision had a dramatic impact, yet it was made without SEC rulemaking and as the result of a "decentralized, issue by issue, review" that yields "whimsical changes in direction" and, in their view, does not well serve the majority of shareholders.

Staff Legal Bulletin 14I

SLB 14I primarily relates to two bases for exclusion of 14a-8 shareholder proposals: economic relevance and ordinary business. The economic relevance exception permits a company to exclude from its proxy statement shareholder proposals regarding operations that are not significantly related to the company's business. The ordinary business exception permits a company to exclude proposals that aim to "micromanage" company operations that are properly addressed by management and the board of directors.

With respect to both exceptions, the guidance provided in SLB 14I reflects the SEC's recently articulated perspective that the board of directors is well situated to determine how a proposal relates to the company's business. The SEC will now expect no-action requests under these two 14a-8 grounds for exclusion to include disclosure of the board's process and reasoning in reaching the conclusion that the proposal should be excluded from the company's proxy statement. While the board's analysis is not determinative, the SEC staff will give it due consideration. Mr. Matt McNair, of the Division of Corporation Finance, indicated in recent remarks that, while formal resolutions and board materials are not required to be included in a no-action submission, the information considered by the board and the board's findings and process should be described in detail and will be of increased importance to the SEC staff under this guidance. Mr. McNair also noted that though the board may delegate the matter to a committee, a well-developed record prepared by a board committee and approved by the full board is likely to carry more weight with the SEC staff.

SLB 14I is likely to have a range of positive effects. It may increase the number of proposals that are properly excluded under these two exceptions. At the same time, it may prompt proponents to submit proposals that are in fact relevant to the business of the corporation and thus could lead to improvements in governance or corporate direction. Given that the disclosures made in no-action letter requests are public, boards certainly will find their deliberative processes in this area under greater scrutiny by institutional shareholders; this may have the additional benefit of encouraging boards and shareholders to engage and negotiate in lieu of going through the shareholder proposal exclusion no-action process.

Further Elements of Reform

The federal government and independent groups have recognized the need for additional elements of shareholder proposal reform. Both the Chamber of Commerce and the Business Roundtable have recommended that disclosure and resubmission requirements be strengthened, and the Business Roundtable has advocated raising the eligibility requirements as well. Increases in the ownership eligibility and resubmission thresholds are key elements of the shareholder proposal reforms contained in the Financial CHOICE Act of 2017, which passed the House of Representatives in June but is stalled in the Senate. The U.S. Department of Treasury released in October a report recommending revisions to the eligibility and resubmission thresholds in order to promote shareholder accountability and reduce unnecessary costs. In remarks earlier this month, at the PLI 49th Annual Institute on Securities Regulation, Chairman Clayton noted with respect to shareholder proposal reform that ownership and resubmission requirements are of particular interest to many.

Every aspect of the shareholder proposal process has come under fire from interested organizations, particularly since the controversial SLB 14H in 2015. Eligibility and resubmission requirements, disclosure requirements, a range of exceptions, proposals by proxy, and the use of graphs and images in proposals (which latter two were addressed in SLB 14I), and the SEC's no-action process itself have been cited as contributing to a situation that is burdensome and counterproductive for the average investor. Yet under the right regulatory regime, shareholder proposals can be a valuable piece of the corporate governance framework. SEC Chairman Clayton has expressed support for the type of shareholder proposals that, despite their short-term costs, can ultimately lead to improvements in corporate governance, and he appears committed to reshaping the shareholder proposal process into one that adds value for investors.

As Chairman Clayton observed in his remarks at the PLI, "the shareholder proposal process is a corporate governance issue that is subject to diverse and deeply held beliefs." To successfully reconcile competing views in governance and shareholder engagement issues generally, Chairman Clayton's focus on "serving the long-term interests of Main Street investors" is the right approach. As boards of directors are the primary guardians of and advocates for long-term shareholder value in our economy, the SEC is wise to elevate their role in this important area of corporate governance. SLB 14I is a first step in the right direction toward meaningful 14a-8 reform.

Tab VI: Board Composition

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Boardroom Accountability

Posted by Michael Garland and Rhonda Brauer, New York City Office of the Comptroller, on Thursday, March 1, 2018

Editor's note: Michael Garland is Assistant Comptroller for Corporate Governance and Responsible of Investment and Rhonda Brauer is Director of Corporate Engagement in the Office of New York City Comptroller Scott M. Stringer. Comptroller Stringer is investment advisor to, and custodian and a trustee of, the New York City Pension Funds. This post is based on a recent campaign launched by the New York City Pension Funds and Comptroller Stringer.

Following up on the successful "Boardroom Accountability Project" launched in the fall of 2014 to give investors a meaningful voice in director elections through proxy access, New York City Comptroller Scott M. Stringer and the New York City Pension Funds (the "NYC Funds") launched the "Boardroom Accountability Project 2.0" in September 2017. The next phase of the campaign ratchets up pressure on companies to improve the quality of their boards of directors, with particular emphasis on diversity of gender and race and on climate competence, so that they are positioned to deliver better long-term sustainable returns for investors.

The effort is the logical next step for the Boardroom Accountability Project, in which the NYC Funds negotiated company-by-company to make proxy access—the right for shareowners to nominate directors using the corporate ballot—a market standard. Today, more than 450 companies provide proxy access, including over 65% of the S&P 500, up from about six companies when the Project was launched in the fall of 2014.

Proxy access provides long-term investors with a powerful tool. The mere specter of a proxy access candidate is expected to make boards more responsive to shareowner engagement, particularly with respect to board composition, thereby limiting the need for its actual use. Boardroom 2.0 is an ambitious effort to test this theory.

As part of the Boardroom 2.0 launch, therefore, Comptroller Stringer sent letters to the nominating/governance committee chairs of 151 companies requesting a dialogue on their processes for adding, evaluating and replacing board members (*i.e.*, board refreshment and evaluations). The letter also identified the board's process for soliciting shareowner input for potential candidates who are women and people of color as being among other potential discussion topics.

The recipients of the letter include 139 companies that enacted proxy access after receiving a proxy access shareowner proposal from the NYC Funds (Template letter A) and 12 at which the NYC Funds' proposal received majority support in 2017 (Template letter B). In most cases, the companies were initially targeted for proxy access because their board lacked adequate diversity or granted excessive CEO pay, they are carbon-intensive energy companies that face substantial risks related to climate change, or they are among the NYC Funds' largest portfolio companies.

In addition to the requested dialogue, the Comptroller's letter asked that each company disclose publicly a meaningful board matrix identifying each director's most relevant skills, experience and attributes in light of the company's long-term strategy and risks, as well as each such individual's gender and race/ethnicity. At some of the companies, the NYC Funds subsequently submitted shareowner proposals requesting a board matrix that, among other attributes and qualifications, includes each director's gender and race/ethnicity.

The initiative comes at a transformative moment in the way the NYC Funds, among other institutional investors, approach board of director engagement and voting. Director independence and accountability remain essential, but they are no longer viewed as sufficient. Investors today want to ensure we have the right directors in the boardroom, with the necessary mix of relevant and diverse skills, experience, attributes and perspectives to provide strong and effective oversight. For the NYC Funds and a growing list of other investors, this includes an explicit focus on diversity of gender and race/ethnicity.

There is a large and growing body of empirical research that suggests a positive correlation between board diversity and performance. Research by McKinsey, for example, suggests that companies with greater gender and ethnic board diversity have stronger financial performance.[1] Similarly, MSCI research suggests that gender diverse boards have fewer instances of bribery, corruption, and fraud.[2]

More and more boards report that recruiting diverse directors is a priority, and there is some evidence that this may be the case. In 2017, for example, white men for the first time represented a minority of the new directors added to S&P 500 companies, according to the 2017 Spencer Stuart U.S. Board Index.[3] Look a little deeper, however, and it's apparent that for too many boards increasing diversity is only a priority when it is convenient; it is a priority that lacks any sense of urgency.

The root of the problem is that, rather than rely on robust director assessment and refreshment processes, which require board leaders to have difficult conversations with directors who are underperforming or whose particular qualifications are no longer as relevant to the business, too many boards only recruit new directors to fill vacancies created when directors hit the board's retirement age or term limit.

This has significant consequences. Despite the high percentage of new women and minority directors in 2017, representation of women on S&P 500 boards inched up only 1%, from 21% to 22% of directors, and representation of African-American and Hispanics/Latino directors at the top 200 S&P 500 companies has not significantly changed over the past five to 10 years.[4] Equally

[1] https://www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters
[2] https://www.msci.com/documents/10199/04b6f646-d638-4878-9c61-4eb91748a82b
[3] https://www.spencerstuart.com/-/media/ssbi2017/ssbi_2017_final.pdf?la=en&hash=DADA958C9B4F21467A69938FF1C44D490AB93D58
[4] Ibid.

concerning, 46% of the 886 directors who participated in PwC's 2017 Annual Corporate Directors Survey sit on a board with at least one director they believe shouldn't be there.[5]

The kind of meaningful board matrix requested by the NYC Funds—in which only each director's most relevant qualifications are highlighted (and supported by more comprehensive detail in each director's biography)—provides shareowners a "big-picture" view of directors' attributes and how they fit together overall to provide the highest oversight competence around the boardroom table. By having the matrix go beyond the minimum qualifications that boards believe must be met by all nominees, boards enable investors to (a) better assess how well-suited individual director nominees are for the company in light of (i) the company's evolving business strategy and risks and (ii) the overall mix of director skills and experiences; (b) more easily identify any gaps in skills, experience or other characteristics; and (c) make better informed proxy voting decisions.

The use of a matrix to present director qualifications is recommended by the National Association of Corporate Directors[6], among other business and investor groups. While many boards, as part of their board refreshments process, may already use a matrix to identify gaps in skills and experience in light of their company's evolving strategy and risks, the EY Center for Board Matters recently reported that only 16% of S&P 500 companies publicly disclosed a director skills matrix in 2017.[7]

The quality of those matrices that are disclosed is mixed at best and even the more useful disclosed matrices almost never include individual directors' gender and race/ethnicity. This is the state of play, despite the fact that many boards reportedly recognize the importance of, and disclose information on, their boards' gender and racial/ethnic diversity and their policies on casting the net widely to include women and people of color in all or most of their new director searches:

- According to a 2017 PwC survey of 886 directors, 68% believe gender diversity is very important and 42% believe racial diversity is very important. Among those who responded that diversity is important, 82% said it improved board performance and 59% said it improved company performance.[8]
- According to a 2017 Equilar study of 500 large companies, 45.1% disclosed board composition by gender and 39.8% disclosed composition in terms of race/ethnicity.[9]

The specific matrix approach requested by the NYC Funds, with gender and race/ethnicity as critical dimensions, is consistent with the request in a March 31, 2015 rulemaking petition to the U.S. Securities and Exchange Commission seeking mandatory matrix disclosure by all U.S. public companies, which Comptroller Stringer submitted jointly with eight other major U.S. pension systems.[10]

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[5] https://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2017-annual-corporate–directors–survey.pdf

[6] https://www.nacdonline.org/Resources/Article.cfm?ItemNumber=35337

[7] http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf

[8] https://www.pwc.com/us/en/governance-insights-center/annual-corporate-directors-survey/assets/pwc-2017-annual-corporate–directors–survey.pdf

[9] http://semlerbrossy.com/wp-content/uploads/Equilar-Board-Composition-and-Director-Recruiting-Trends-SEP-2017.pdf

[10] https://www.sec.gov/rules/petitions/2015/petn4-682.pdf

The initial response rate to the Boardroom 2.0 engagement letters has been extremely high, a significant validation the underlying theory of proxy access, and the resulting engagements have been overwhelmingly positive. Through March 2018, the Comptroller's Office has had meaningful engagements with over half of the companies, with many more engagements on the horizon, and has withdrawn some matrix proposals.

Director engagements have gone particularly well, with directors often pushing their management teams to go further in terms of their board refreshment processes and proxy statements disclosures. We have had meaningful director discussions on:

1. the qualifications that they want to have around their boardroom tables and how that relates to the company businesses and long-term strategies they have a fiduciary duty to oversee;
2. how they seek out all or most director candidates from pools that include women and persons of color (the so-called "Rooney Rule" of corporate governance);
3. how robust their board evaluation processes are, including how they evaluate each director individually in terms of their ongoing capability and availability to continue to serve and be nominated for election each year; and
4. the importance of gender and racial diversity, among other types of diversity, to avoiding "group-think" in their boardrooms. These discussions have included not only examples of how they have increased such diversity on their boards (often with first-time directors), but also the ongoing sensitive nature of race discussions that remain in their boardrooms, corporate America, and our society at large.

We have been repeatedly told that we are changing the nature of the discussion of these issues in U.S. boardrooms. These discussions reflect the broad continuum on which these companies and their boards are admittedly operating, with some further along than others and many aware of where they see themselves moving in the coming months and years. We expect to see enhanced disclosure that reflects our engagements in 2018 proxy statements and beyond, as well as an increasing amount of gender and racial diversity in our portfolio company boardrooms.

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NYC Pension Funds Boardroom Accountability Project Version 2.0

Posted by CamberView Partners, on Tuesday, September 19, 2017

Editor's note: The following post is based on a publication from CamberView Partners, authored by Abe M. Friedman, Erica K. Lukoski, Bob McCormick, and Eric Sumberg.

On Friday, September 8, New York City Comptroller Scott M. Stringer sent a letter to 151 companies seeking engagement around a range of disclosures regarding the race and gender of company directors, the creation of a standardized director skills matrix and details of those companies' director evaluation and succession plans. The letter, sent on behalf of the New York City Pension Funds (NYC Funds), is also intended to put pressure on companies to engage on the topic of pursuing diverse independent board candidates. The request was packaged as part of the launch of the second phase of the NYC Funds' Boardroom Accountability Project, which in its first phase focused on achieving widespread adoption of proxy access.

The NYC Funds have a track record of coordinating among investors to run shareholder proposal campaigns and other initiatives that have received widespread support. In our view, NYC Funds are among the most likely investors to attempt to use the proxy access right. Accordingly, issuers should think carefully about how they manage their response to this outreach.

Proxy Access Campaign

In 2014, Comptroller Stringer filed 75 shareholder resolutions requesting the right for "proxy access," the ability for shareholders to nominate directors using the company's ballot. The Comptroller's office approach was intended to help set a market-standard around the terms of proxy access bylaws. The NYC Funds filed resolutions at companies that fit within three categories that were likely to gain the support of traditional institutional investors: carbon-intensive energy companies significantly impacted by climate change, companies at which executive compensation was misaligned with company performance and companies with limited or no board diversity (in addition to filing at some of its largest holdings).

At the start of the campaign in 2014, just six U.S.-based companies had enacted proxy access bylaws. Today, more than 440 companies have a bylaw in place, including 60% of the S&P 500 and 80% of the S&P 100. The NYC Funds' proxy access proposals routinely receive majority support and a significant number of issuers now preemptively adopt a proxy access bylaw to avoid a vote on the shareholder proposal.

Boardroom Accountability Project Campaign—Version 2.0

The next phase of Comptroller Stringer's Boardroom Accountability Project seeks to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent, so that they are in a position to deliver better long-term returns for investors." The 151 U.S. companies that received the letter include those that enacted proxy access after receiving a shareholder resolution from the NYC Funds and companies at which an NYC Funds- sponsored proxy access proposal received majority support in 2017. The letter requests that companies disclose the demographic background, skills and experience of directors in a standardized "matrix" format and enter into a dialogue regarding their board refreshment process.

The Comptroller's letter also outlined four sample engagement topics that representatives from the NYC Funds would like to discuss with a member of each recipient's Nomination/Governance committee, including:

1. The matrix currently used by the board to help them and investors understand the range of skills and experiences the board considers most critical and how current directors and potential board candidates best serve the Company's long-term business strategy, executive succession planning process and risk oversight responsibilities.
2. Understanding how the company evaluates individual directors on an ongoing basis, to assess whether and how directors continue to contribute to the above board responsibilities and to changing responsibilities over time. This would also include discussing what processes are in place for companies to discuss board transitions in cases where a particular director no longer is able to contribute in this way.
3. How to establish a process whereby director search firms that a company may retain, would regularly reach out to significant shareowners for suggestions for the names of both potential board candidates and other organizations that specialize in sourcing potential diverse board candidates.
4. How to establish a normalized and structured process, pursuant to which the NYC Funds and other significant shareowners may provide to Nominating/Governance Committees the names of potential board candidates, on an ongoing basis.

Of these four topics, the Comptroller's letter focuses most of its attention on the board skills matrix. According to the letter, disclosure of a matrix allows investors to assess how well-suited individual director nominees are for the company, identify any gaps in skills, experience or other characteristics, and to more fully exercise shareholder voting rights. The NYC Funds also published a sample matrix, displayed below, that outlines the skills and experience of individual directors as well as their tenure, sexual orientation, gender, age and race/ethnicity.

[Insert Your Organization Name]

Board Matrix

This sample matrix can help boards and investors assess the level of experience each company director/nominee has in various areas, as well as in the areas of gender, sexual orientation and racial/ethnic diversity, age and tenure.

	Board of Directors							
	Name 1	Name 2	Name 3	Name 4	Name 5	Name 6	Name 7	Name 8
Skills & Experience								
Board of Directors Experience	X			X				
[Specific] Industry Experience		X					X	
CEO/Business Head	X			X				
International	X					X	X	
Human Capital Management/Compensation			X				X	
Finance/Capital Allocation		X			X		X	
Financial literacy/Accounting (Audit Committee Financial Expert or "ACFE")			X			X		
Government/Public Policy	X			X				
Marketing/Sales			X		X			
Environmental Science/Policy/Regulation						X		
Academia/Education								
Risk Management				X				
Corporate Governance		X						X
Technology/Systems					X			X
Business Ethics			X			X		X
Real Estate		X			X			X
[Custom 1]								
Demographic Background								
Board Tenure								
Years	15	15	10	8	7	7	4	1
Sexual Orientation (voluntary)								
LGBTQ	X							
Gender								
Male		X	X	X	X	X		X
Female	X						X	
Non-Binary								
Age								
Years old	60	63	65	62	60	67	55	47
Race/Ethnicity								
African American/Black	X							
Asian, Hawaiian, or Pacific Islander								
White/Caucasian		X	X	X		X	X	X
Hispanic/Latino					X			
Native American								
Other								

Takeaways for Issuers

Certain themes in this phase of the Boardroom Accountability Project, such as boardroom diversity and climate risk, are likely to resonate with the investor community. However, much of the NYC Funds' request is forward-leaning and some investors may consider it overly prescriptive or not necessary for all companies. It is not clear that investors would broadly support shareholder proposals on these topics unless they were fairly high-level and focused on the overall objective of boardroom diversity. However, this phase of the campaign may be a precursor to identifying companies at which the NYC Funds may seek to run a proxy access campaign in the future.

Companies that received the letter and have risk on topics where a shareholder proposal might receive broad-based support should consider engaging with their investors to assess what, if anything, investors would like to see them do around the issues outlined in the NYC Funds letter. Given the deliberate approach being taken toward engagement by the NYC Funds, all issuers may want to begin evaluating their practices against industry standards and conducting analyses of their board diversity and composition, as well as their board's processes for evaluation and regular refreshment. In addition, issuers should review and consider whether enhancements to their governance-oriented engagement on these topics is appropriate.

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Corporate Governance Update: Boards, Sexual Harassment, and Gender Diversity

Posted by David A. Katz and Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, on Friday, January 26, 2018

Editor's note: David A. Katz is partner and Laura A. McIntosh is consulting attorney at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication by Mr. Katz and Ms. McIntosh which originally appeared in the *New York Law Journal*.

In light of recent events, corporate directors may consider adding an item to the agenda for their next board meeting: the issue of potential sexual misconduct at the company. A recent study indicates that the topic would be new for most public company boards, notwithstanding the fact that it relates to key elements of board-level governance: company culture, tone-at-the-top, risk management, and crisis management. Sexual misconduct in the workplace can take a devastating human toll. Moreover, the issue implicates gender equality and gender diversity concerns more broadly, and boards that include a meaningful proportion of female directors should be better positioned to address sexual harassment and gender equality issues.

Risk Assessment and Action Plan

"Sexual harassment is becoming a serious investment risk," announced *Barron's* in November 2017. Yet most boards of directors still underestimate the downside risk from sexual misconduct allegations at their companies. A 2017 survey of 400 private and public company directors by Boardlist and Qualtrics revealed that "the vast majority of boards (77 percent) had not discussed accusations of sexually inappropriate behavior and/or sexism in the workplace. Nearly all (88 percent) had not implemented a plan of action as a result of recent revelations in the media or re-evaluated the company's risks regarding sexual harassment or sexist behavior at the workplace (83 percent)." The relatively small survey was undertaken before the shocking Harvey Weinstein allegations, but the results remain telling. Sexual harassment can take many forms and is not restricted to a single gender.

Many boards believe that, in the absence of specific complaints, and in the absence of public allegations against firms in their industry, their company does not have a problem. However, the growing societal awareness of misconduct—and of the potential power of misconduct allegations—is creating an environment in which more complaints are made and rise to the level of boardroom notice. Advance preparation is essential for a prompt and effective response.

Boards must take seriously the risks of sexual harassment claims relating to their corporate environment and their personnel. The damage can be seen in headlines almost daily: first and foremost, injured/impacted employees; in addition, negative publicity, the loss of high-profile employees, reputational damage, the inability to attract top talent, the possibility of false accusations, the defections of clients and customers, an immediate impact on the company's stock price, and of course, the cost and disruption of defending burdensome lawsuits. While sexual misconduct allegations are not necessarily a "risk factor" for a company with no reason to believe that any such claims are forthcoming, boards that have not discussed the issue in that context should consider doing so. At a minimum, boards should seek to understand the risks relating to this issue and the company's history, if any, with respect to such claims.

From an oversight perspective, sexual harassment in the workplace is a management and governance issue like many others. The board should review the company's policies and procedures regarding sexual harassment or assault allegations. In addition, the board may want to be briefed on the company's employee training and protocols for preventing, reporting, and addressing sexual misconduct. The board should consider its oversight role in the process and be briefed on the factors used by management in determining which claims are reported to the board (or the relevant board committee). The board may want to hear from counsel as to litigation risk, disclosure requirements, and the importance of maintaining attorney-client privilege in this context. The board could discuss relevant aspects of risk management, particularly with respect to any situations that involve senior leadership, repeat offenders, or a pattern of complaints. Ideally, the board and management should consider the necessity of developing a crisis response plan that includes participation from human resources, public relations, and legal counsel. With a team and plan in place, the company should be better able to respond to a situation quickly and in a coordinated fashion.

Gender Diversity and Sexual Harassment

The steady increase in women directors on public company boards is a positive development for many reasons. In the context of sexual harassment allegations, gender diversity can be invaluable. The perspective and insight of female directors in board meetings adds immeasurably to substantive discussions and enhances the legitimacy—both actual and perceived—of board decisions. Companies with all-male governance at the board and senior executive level are frequently subject to negative publicity for their lack of gender diversity, particularly when allegations of sexual misconduct or gender discrimination come to the fore.

The leadership of women in senior management positions as well as on the board is essential to the establishment of a corporate culture in which sexual misconduct is taboo. Corporate culture (and the related tone-at-the-top) is created in large part by example and perception, and the influence of women leaders promotes an environment in which gender equality is presumed, harassment is unacceptable, and fair treatment is expected. That said, it is important to note that a diverse team cannot be successfully created through a superficial compilation of representatives from various identity groups. Not only does this approach devalue the talents of those who are thereby reduced to one or more identifiers, but it limits their ability to contribute meaningfully in areas beyond a narrowly defined category. No worthwhile director, executive, or employee would take pride in being hired solely for the sake of diversity, and a team assembled in such an artificial manner would neither reap the benefits nor possess the legitimacy that it seeks. Indeed, in a healthy, productive corporate culture, all employees feel valued for their work and talents, not on account of their gender or other identity characteristics.

Going forward, each board should regularly consider taking a hard look at its company culture. Directors should consider the actions necessary to become confident that their culture is one in which misconduct will not be tolerated and any sexual harassment allegations will be addressed promptly and fairly. By being proactive, they can better ensure that, should a serious allegation arise, management and the board are ready to act swiftly to protect employees, curtail ongoing misconduct, and minimize harm to the company, its shareholders, and other stakeholders.

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CEO Gender and Corporate Board Structures

Posted by Melissa B. Frye (University of Central Florida) and Duong T. Pham (Georgia Southern University), on Wednesday, January 10, 2018

Editor's note: Melissa B. Frye is an Associate Professor of Finance at the University of Central Florida and Duong T. Pham is an Assistant Professor of Finance at Georgia Southern University. This post is based on a recent article by Professor Frye and Professor Pham, forthcoming in the *Quarterly Review of Economics and Finance*.

In our article, CEO Gender and Corporate Board Structure (forthcoming in the *Quarterly Review of Economics and Finance*), we investigate the relationship between the gender of the CEO and corporate board structures. In recent years, women have made strides in cracking the glass ceiling in leadership positions in corporate America. Female CEOs have been appointed not only in female-friendly industries such as healthcare and consumer products but also in fields that are traditionally dominated by their male counterparts such as energy, utilities or automotive. The number of female CEOs leading S&P 500 companies reached a record high in 2016 with 27 women at the helm of these firms. However, women CEOs only make up 5.4% of the total S&P 500 CEO positions.

A growing body of academic research in finance shows that gender matters in terms of value enhancing decision making. Studies have documented that male executives carry out more acquisitions and issue more debt than their female counterparts, consistent with men being more overconfident than women and less effective corporate decision makers. Research has also shown that firms run by female CEOs have lower leverage, less volatile earnings, and a higher chance of survival than male CEO firms.

Since corporate governance helps mitigate agency conflicts between managers and shareholders of the firm, a good governance system is believed to enhance firm value. In our study, we focus on what is viewed as the most important governance mechanism for shareholders. The board of directors are trusted with monitoring and advising the firm's management and protecting shareholders' interests. While the literature has explored mechanisms that are associated with effective governance, the question of whether behavioral differences, associated with the gender of the CEO, play a role in shaping monitoring structures has not been addressed. Thus, we examine whether the "woman effect" in corporate decisions and performance extends to board structures. Essentially, we explore whether behavioral differences between men and women may lead to different board structures.

Whether female CEOs are associated with boards structured for more or less monitoring is an empirical question. To explore this, we consider three hypotheses based on documented behavioral differences between males and females. First, female CEOs may establish boards with greater monitoring. The channel between more board monitoring and gender comes from the literature on negotiations, overconfidence, and stereotyping. Several prior studies report that women perform worse than men at the negotiation table. Basic agency theory would suggest that all CEOs prefer less monitoring. Thus, if females are less savvy negotiators, they may not bargain as effectively with respect to board structure. Likewise, differences in overconfidence may lead to greater board monitoring. A male CEO may overestimate his ability and underestimate the role of board monitoring, thus he may seek to reduce board monitoring relative to a less overconfident female CEO. Stereotyping and/or discrimination on the part of the board may motivate directors to force stricter monitoring on a female CEO. Second, we consider that gender-based differences may lead to less monitoring of female CEOs. The conduit for less board monitoring for female CEOs comes from the perception that women leaders would simply need less monitoring. The overconfidence theory may suggest that boards would be less inclined to intensely monitor female CEOs, since women leaders may make better decisions. Third, it is also possible that male and female CEOs will not differ in terms of board structures. Essentially, females that make it to the top of a publicly traded firm may exhibit very similar behavioral characteristics as their male counterparts.

Using a sample of publicly traded firms in the U.S., we focus specifically on board characteristics that alter the efficiency of the monitoring of the board and are also influenced by the CEO. To capture monitoring intensity we use board size, board independence, the ratio of inside to outside directors, the gender diversity of the board, the board network, director age, interlocking directors, board attendance, and an aggregate board monitoring measure. We find that female CEOs are associated with boards of directors that are smaller, consist of more independent directors, have a lower ratio of inside to outside directors, are more gender diversified, have a broader director network, are composed of younger directors and are in general structured for more intense monitoring of the CEOs relative to the industry median, consistent with our first hypothesis.

In general, we provide strong evidence that female CEOs are associated with boards of directors that are significantly different in structure from their male counterparts. Our results are consistent with gender-based behavioral differences in negotiation, overconfidence, and/or discrimination leading to greater board monitoring at female-led firms. Prior literature shows that better governance is viewed positively by the market and leads to better performance. Activists and regulators also put significant weight on effective monitoring. In light of this, our study supports the push to increase the number of women leaders. Our findings suggest female CEOs welcome board monitoring and stronger governance structures.

The complete article is available for download here.

Tab VII. The Continuing Debate Over Dual-Class Stock

Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance

Posted by Kara M. Stein, U.S. Securities and Exchange Commission, on Thursday, February 15, 2018

Editor's note: Kara M. Stein is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Stein's recent remarks at Stanford University, available here. The views expressed in the post are those of Commissioner Stein and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff.

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Tonight [Feb. 13, 2018], I want to talk to you about something that has been vigorously debated in recent years: What is, and what should be, the role of the corporate shareholder? In the spirit of being in California, this debate could be summarized as follows: Are shareholders merely extras in the corporate movie? Or are they lead actors that need to be empowered so that they can successfully play their roles? However, as most people in this room know, it is actually much more complicated than that. It is not, and should not be conceptualized as, a binary choice. Rather, I would posit that the entire corporate ecosystem's success actually rests on effective communication and collaboration between corporations and their shareholders. When a company, its management, its shareholders, and its employees work together, companies tend to be more resilient and prosperous. In turn, this benefits companies, their corporate stakeholders, and the economy as a whole.

Today's corporations influence and impact our society in a multitude of ways. Corporations help grow our economy, provide well-paying jobs, and provide earnings to investors saving for retirement, college, or a new home. Many companies, whether small or large, are helping to drive our society forward, developing new technologies that are raising our living standards, improving our environment, and lengthening our life span. Corporations hold some of our most precious assets, such as medical histories, consumer bank account information, addresses, and other sensitive information. They also are central players in some of our most immediate problems, such as global warming.

Corporations have shaped, and will continue to shape, our society, our identities, and our relationships with one other. This week's series seeks to promote a discussion of the interrelationship and interdependency between corporations and our society. Pretty heady stuff, to be sure, but extremely important. Not only from an academic point of view, but from a practical and policy point of view, as well.

So, I thought I would start off our discussion tonight by talking a bit about the science of "mutualism." For those of you not familiar with the concept, mutualism is a symbiotic relationship between individuals of different species in which both benefit from the association. One example of mutualism is the relationship between bees and flowers. Bees fly from flower to flower gathering nectar to make food. By flying from flower to flower, bees pollinate the plants on which they land. Bees get to eat, and the flowering plants get to reproduce. Bees help plants grow, thus supporting other animals, including us humans. The bee-flower relationship is integral to our entire food chain, and our larger ecosystem.

The relationship between a company and its shareholders is rooted in a similar form of mutualism. Shareholders invest their savings or capital in a company. The company then deploys the capital to fund its operations. This allows the corporation and its shareholders' investments to grow. This corporation-shareholder relationship is likewise part of a larger ecosystem. When all goes well, more employees and managers get hired, and the company produces more products or provides more services, all of which benefits the entire economy.

Unfortunately, the relationship between corporations and their shareholders may be moving away from its origins and becoming less mutualistic. This, I believe, may harm companies and their shareholders, as well as those who depend on the health of the corporation-shareholder relationship.

So, how do we restore mutualism in the relationship upon which our corporate ecosystem is based?

Mutualism and the Corporation-Shareholder Relationship

Brief History

I recently remarked upon the history of the American corporate form, and I would like to start my talk tonight there, as well. Don't worry, I won't go as far back as the Dutch East India Company and its *participanten,* or the tulip bulb market. Rather, I will quickly touch upon the history of the corporation-shareholder relationship in the United States to inform the rest of our discussion.

From the late-1700s to the mid-1800s, corporations started to flourish in the United States. American companies typically operated within a single state or community. The shareholders of a corporation were often members of the same community in which the corporation was located. As a result, they were able to engage and monitor the company's business affairs in a more direct manner than we currently see today. A corporation also met with its shareholders more frequently, whether in the form of shareholders' meeting or otherwise.

Beginning in the mid-1800s, however, companies started growing larger and the corporate form changed. Companies began hiring managers—who often had no ownership interest in the companies—to run their affairs. While this transition created certain efficiencies, it also in many cases separated the ownership of the company from the management of the company. This had the effect of reducing shareholders' ability to directly influence the company's business.

Mutualism and the Corporation-Shareholder Relationship in Recent Years

A lot has happened since the mid-1800s, and we are now at a tipping point. Instead of being in the midst of an industrial revolution, we are in the midst of a digital revolution. This new revolution comes with many benefits—speed, efficiency, and innovation, to name only a few. Coupled with these benefits, however, are also some risks. I think if we focus on the strengths of the American corporate form, we can successfully reimagine the corporation-shareholder relationship for the Digital Age.

I would like to discuss a few examples of how, in modern corporate governance, the concept of mutualism can help us think through the path forward for corporations, their shareholders, and the larger corporate ecosystem.

Cyberthreats

As we all know, the digital transformation is providing both companies and shareholders with tremendous opportunities. However, one of the biggest challenges facing corporations and their shareholders, their employees and consumers, and our economy as a whole, is cybersecurity. As we have learned, cyberattacks can affect millions of people at once and potentially compromise our most sensitive personal information.

Shareholders have been out front advocating for more information on company practices relating to cybersecurity. The number of shareholder proposals regarding cybersecurity has increased in recent years. But good information remains scarce. Unfortunately, corporate disclosures are far from robust and largely consist of boilerplate language that fails to provide meaningful information for investors.

While companies and shareholders agree that cybersecurity is one of the most prominent corporate issues of our time, it is unclear why companies are not doing more to implement robust cybersecurity frameworks and to provide meaningful disclosures regarding the risks of data loss.

Companies and their intermediaries tend to view cyberthreats as a technology problem instead of, more appropriately, a business risk. As we have seen time and time again, cybersecurity, and the related threats of unintentional loss of data, is a governance challenge for all of us, and it requires a change in culture and approach. Many shareholders seem to understand this and have been urging, and continue to urge, companies to engage.

Regulators are certainly not immune from facing these challenges. In August 2017, I learned for the first time that the Commission's official record system was breached in 2016, and that this breach may have provided the basis for illicit gains through trading. Clearly, the Commission's enterprise risk management processes failed to adequately address appropriate escalation protocols. Once he was informed, Chairman Clayton immediately launched an investigation into the breach and has focused the Commission and the staff on improving our risk management framework.

Companies, their managers, their boards, as well as their regulators, all need to do a better job in recognizing and addressing the significant risks that can result from the loss of data. Breaches of security measures can result in theft, reputational harm, or the loss of intellectual property. Simply put, the unintentional loss of data may have material effects on companies. Slowly, regulators around the globe are stepping up to the challenge of issuing data protection laws and regulations. The approach to these issues continues to evolve with the changing landscape. For example, the European Union's General Data Protection Regulation is set to go into effect in May 2018. China has begun enforcing regulations concerning “critical information infrastructure.” Last March, the New York Department of Financial Services required that regulated firms name a chief information security officer (or CISO). These CISOs must provide an annual report on cybersecurity to the firm’s board. Last year, a bipartisan bill was introduced in the Senate to require publicly traded companies to disclose whether any members of their board have cybersecurity expertise.

We at the Commission have not yet adequately pressed forward. While the Commission’s staff has released disclosure guidance for public companies to consider when dealing with cyberrisks and breaches, the Commission can and should do more. I believe the Commission should consider rules to require disclosure of a firm’s enterprise-wide consideration of cyberrisks. I also believe that we should develop rules to ensure that market intermediaries, including broker-dealers and investment advisers, develop and implement policies and procedures to protect investors’ personal information.

The security and integrity of a corporation’s assets, like the SEC’s, is a great responsibility. As I said earlier, cybersecurity has been viewed by many as simply an “IT” problem, hoisted on the shoulders of a company’s chief information officer. Too often, this has led to a failure to integrate cybersecurity into a firm’s enterprise risk management framework. To be sure, some companies are focused on cyberthreats and recognize their potential economic threat. But companies need to do more than simply recognize the problem. They need to heed the calls of their shareholders and treat cyberthreats as a business risk. Corporations and shareholders will both benefit from greater transparency and focus on the risks related to unintended data loss and the collateral consequences.

Board Composition

The composition of corporate boards provides another example of how the concept of mutualism is informative. Boards can and should be a bridge to investors, but too often they are a wall. Board composition is vitally important as directors play a meaningful role in helping companies make productive investments and good decisions going forward. However, boards remain far from diverse or reflective of shareholders’ views despite evidence pointing to the value of such diversity in their composition.

Gender diversity on boards provides a notable example. This is not about making people feel good—it is about dollars and cents. Studies suggest that women may be better monitors of executives, a central function of boards of directors. Research has also shown that companies with strong female leadership generated higher returns on equity compared to those without. This may be because having a diverse board helps the company better understand purchasing and usage decisions by its clients or customers. Studies have found, after all, that women drive 70% to 80% of purchasing in the United States. As I have remarked in the past, diverse boards also appear to deter “groupthink” and help reduce instances of fraud, forms of corruption, and shareholder contests. The Commission and regulators across the globe have also echoed the importance of gender diversity on boards.

Despite all of this, gender diversity on boards remains elusive. The percentage of women on boards is currently at approximately 20%, an increase of only 5% since 2011. This is striking when you consider that women make up 50.5% of the U.S. population and approximately 47% of the U.S. labor force. Indeed, the United States lags behind many advanced economies in terms of women's representation on corporate boards.

More striking still, it is not just academics and think tanks that support gender diversity on boards. Shareholders, too, expect the companies they own to have diverse board membership. For example, State Street Global Advisors and BlackRock have adopted policies or guidance with respect to increasing gender diversity on boards, and indicated their willingness to use their voting power to effect change, if necessary.

Yet, despite the documented benefit of diverse boards, many board members do not believe that board diversity enhances company performance. Further, more than half of directors believe that their boards are already sufficiently diverse.

It is one thing for boards to ignore scholarly research, but it is quite another for boards to ignore their companies' shareholders or owners. Especially when it can affect everyone's bottom line. Although we have come a long way since the 18^{th} Century, we still have a long way to go. How can technology help this process? Can it be used to better connect a company and its board with its shareholders? How can a corporation capitalize on mutualism and benefit from the best ideas of its shareholders for the benefit of all?

Shareholder Activism

Changes in the corporation-shareholder relationship are perhaps most apparent when looking at efforts to curtail shareholders' information and rights. As owners of a company, shareholders actually care about corporate practices of all types and how they affect the bottom line—from strategic plans to employee relations to executive compensation, and much more. So-called shareholder activism can provide a necessary check on a company's leaders. Or it can be a needless expense for a company ultimately producing no benefit. Whatever your opinion, shareholder activism seems to be here to stay, with 39% of directors believing that there will be an increase in shareholder activism in 2018.

In recent years, shareholder activism has prompted myriad responses from corporate boards and management. Many simply try to fend off shareholders. Many engage with shareholders, but because about 70% of the share ownership of U.S. companies is from huge investors, that is where they focus. Thus, the entire battle is fought for the opinions of a handful of executives at large asset managers.

Though the decision to engage institutional shareholders may simply be a matter of numbers, what are the long-term effects *on the company* of this sort of narrow shareholder engagement? Does engaging the view of only one group of shareholders result in a form of short-termism? Could it result in a company putting on blinders that can affect its long-term bottom line? Ultimately, how does this sort of one-sided engagement affect the company's position in the larger ecosystem?

In effect, is shareholder activism a symptom of an underlying problem or part of the cure? I believe that we need to get back to a more mutualistic relationship in order to properly answer that question.

Dual-Class Capital Structures

Another place where the concept of mutualism needs to be considered is in regard to dual-class capital structures, where certain shareholders are starting to be disenfranchised *by design*.

As you know, in typical dual-class capital structures, corporate insiders receive common stock with multiple votes per share while public shareholders receive shares with one vote per share. This structure allows these corporate insiders to control a majority of the votes of the corporation even though they own a minority of its stock. While dual-class capital structures have existed for many years, much has been written about them recently. This may be in part because of an upsurge in dual-class IPOs—from Google in 2004 to Manchester United in 2012. And we all have heard about Snap and its IPO of *non*-voting shares in 2017.

Many, including myself, see dual-class capital structures as inherently undemocratic, disconnecting the interests of a company's controlling shareholders from its other shareholders. The disassociation of interests can grow over time when certain shareholders, but not others, have the right to vote over fundamental corporate matters—like board members. It is not surprising, then, that critics include shareholder groups, asset managers, and stock indices. Or that they are prohibited by some countries. Yet, we are still inexplicably letting dual-class share structures persist.

Why does the appetite for dual-class capital structures exist despite wide investor disapproval of such structures? Where is the symbiosis? Can investors afford not to invest in another Google, even if they do not agree with the share structure? What leverage do they have? What happens when the interests of a company's controlling shareholders continue to diverge from its other shareholders? Is there a risk that a company's controlling shareholders will acquire conflicts of interest so large that the company cannot act in the best interests of all of its shareholders?

While some say dual-class capital structures are designed to prevent a takeover or shareholder activism, they also may provide a means to evade management and board accountability. Structures where a minority of insiders lock out the interests and rights of the majority may also have collateral effects on our capital markets. They may be harmful not just for those companies, their shareholders, and their employees, but for the economy as a whole. Dual-class capital structures, in effect, turn the mutualism underlying the corporation-shareholder relationship on its head.

A Way Forward

While it is clear that the relationship between a company and its shareholders is currently in flux, it is less clear how we should move forward. How can we restore the mutualism that serves as the foundation for the corporation-shareholder relationship, and that has benefited companies, their shareholders, and the economy as whole since the 1700s?

Shareholder empowerment is key. As I have discussed tonight, the benefits of shareholder involvement are not abstract. Shareholders often fight for corporate values—such as diverse boards—that empirically have positive, direct effects on the corporate bottom line. They often do this well before managers or boards are willing to consider or implement such changes. Despite this, corporations appear to be searching for ways to ignore shareholders, even on a structural level.

Shareholder engagement is, I believe, a good first step in enhancing the corporation-shareholder relationship for the benefit of both. Despite the trends toward a less mutualistic relationship, there are some positive signs. For example, companies and their shareholders are increasingly sitting down at the same table these days. Companies are also hiring advisors to help them engage directly and consistently with their shareholders. This has allowed companies to have a continuing dialogue with their shareholders.

Many companies are also utilizing technology to better facilitate engagement with their shareholders. From hosting virtual or live webcasts of their shareholder meetings, to using social media and mobile technology, companies are searching for new and better ways to actively engage their shareholders.

Unfortunately, this shareholder engagement has largely been geared toward those with the most voting power. Companies can also benefit from the engagement of retail investors. And, as I have said before, technology can also serve this purpose. After all, more Americans are technology-literate than ever before. Indeed, approximately 80% of Americans had a social media profile in 2016. Perhaps, shareholders should be allowed to vote through social media or a mobile phone application, like in Estonia.

New and cutting-edge technologies may help in other ways. Companies might be able to use distributed ledger or blockchain technology to identify and reach their shareholder bases more effectively. Currently, companies mainly communicate with shareholders through broker or bank intermediaries, because the shares are held in the names of these intermediaries rather than in the names of the beneficial owners. This means that, in some cases, companies do not actually know who their shareholders are. While this complex construct may have been necessary in the 1970s, current technology could enable companies to directly communicate with shareholders without the need for intermediaries.

The Commission can do more, too. While we have issued rules that shape the means by which a company communicates with its shareholders, we should continue to be ready to help fortify the corporation-shareholder relationship as we move forward. For example, we should adopt final rules regarding the use of universal proxy cards. These rules should recognize that few shareholders can dedicate the time and resources necessary to attend a company's meeting in person and that, in the modern marketplace, most voting is done by proxy. The Commission's rules need to change to reflect our current reality, empowering companies and shareholders alike.

In a time when ownership is global and disparate, the use of technology and the Commission's rules are simply tools to further the empowerment of a corporation's owners. We have seen throughout history that a company's growth and its owners' prosperity are often enhanced by direct engagement. In other words, both engaging with one another for the good of all, or mutualism. The result is a corporation that is more nimble and grows in an ecosystem that thrives on transparency. This was true in the 1700s and it is still true today.

* * *

As we move forward, we have to ask ourselves how we can strengthen the corporation-shareholder relationship. For it has been foundational to the success of the American corporate form.

As I have discussed tonight, the corporation-shareholder relationship must be reimagined in the context of modern corporate governance to recapture its benefits. Shareholders, like management, share the desire to grow a company's bottom line. But they can only help if they are heard.

We need to go back to first principles: A corporation's growth and its shareholders' prosperity are intertwined. To succeed, they must work together.

Thank you for your time, and for inviting me to speak with you this evening.

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The complete publication, including footnotes, is available here.

Perpetual Dual-Class Stock: The Case Against Corporate Royalty

Posted by Robert J. Jackson, Jr., U.S. Securities and Exchange Commission, on Friday, February 16, 2018

Editor's note: Robert J. Jackson, Jr. is a Commissioner at the U.S. Securities and Exchange Commission. The following post is based on Commissioner Jackson's recent remarks at the UC Berkeley School of Law, available here. The views expressed in the post are those of Commissioner Jackson and do not necessarily reflect those of the Securities and Exchange Commission, the other Commissioners, or the Staff. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

My first few weeks at the SEC have been a whirlwind—and just to be clear, I am *not* talking about the markets. In a few short weeks, I have gotten a crash course on SEC policymaking—and enough reading to empathize with my former law students, who used to tell me, to my puzzlement, that my Corporate Law syllabus was not exactly beach material.

But in between the policy memos that come across my desk, I've also had the pleasure of working with my new colleagues on the SEC's Staff. They've taught me a lot in a short time, and I'm grateful for their insights and assistance. The hard work and dedication of these folks gives me confidence that we are up to the challenge of making sure our financial markets are the safest, strongest, and most efficient in the world.

So the first few months of 2018 have been quite a blur. Fortunately, they have not been as stressful for me as the last few months of 2017.

You see, last fall, I took part in two of the most nerve-wracking Q&A sessions of my life. In late October, I had the ultimate job interview: a two-hour, televised confirmation hearing in front of the Senate Banking Committee.[1] Then, two months later, I found *myself* the one posing the life-changing questions. I asked my girlfriend Bryana to marry me.

I'm happy to report that, to my surprise, both Bryana and the Senate offered a resounding yes—literally within 24 hours of each other. But, let me just say, I now have newfound respect for the staff and Senators on the Committee. I only had to ask one question, and it nearly gave me a heart attack.

Now, as a newly engaged guy, I fully embrace the notion that a strong marriage must be built on a foundation of eternal trust. But today, I would like to ask whether it is wise to apply that standard

[1] To be fair, I'm using the phrase "televised" a little loosely here. Because my Mom and Dad were present at my confirmation hearing, I'm pretty sure viewership was close to zero.

to corporate governance. Should our public investors have to place eternal trust in corporate insiders? That is, should so-called perpetual dual-class stock ownership structures, which grant corporate executives control of our public companies literally *forever*, be acceptable?

The Law and Legacy of Dual-Class Stock

As you know, "dual class" voting typically involves capitalization structures that contain two or more classes of shares—one of which has significantly more voting power than the other. That's distinct from the more common single-class structure, which gives shareholders equal equity and voting power. In a dual-class structure, public shareholders receive shares with one vote per share, while insiders receive shares that empower them with multiple votes. And some firms have recently issued shares that give ordinary public investors no vote at all.[2]

For most of the modern history of American equity markets, the New York Stock Exchange did not list companies with dual-class voting. That's because the Exchange's commitment to corporate democracy and accountability dates back to before the Great Depression.[3] But in the midst of the takeover battles of the 1980s, corporate insiders "who saw their firms as being vulnerable to takeovers began lobbying [the exchanges] to liberalize their rules on shareholder voting rights."[4] Facing pressure from corporate management and fellow exchanges, the NYSE reversed course, and today permits firms to go public with structures that were once prohibited.[5]

As you all know well, more and more companies choose today to go public with dual-class. Public companies using dual-class are today worth more than $5 trillion, and more than 14% of the 133 companies that listed on U.S. exchanges in 2015 have dual-class voting.[6] That compares with 12% of firms that listed on U.S. exchanges in 2014, and just 1% in 2005.[7]

There's a long-running debate on dual-class. On one hand, you have visionary founders who want to retain control while gaining access to our public markets. On the other, you have a structure that undermines accountability: management can outvote ordinary investors on virtually anything.

There is reason to think that, at least for a defined period of time early in a company's life, dual-class can be beneficial. The structure can allow entrepreneurs to build for the long term—and even transform entire industries—without being subject to short-term pressure.[8] When many

[2] Snap Inc., Form S-1 (February 2, 2017) ("Holders of our Class A common stock—the only class being sold in this offering—are entitled to no vote on matters submitted to our stockholders.").

[3] In 1926, the NYSE's famous decision to list nonvoting shares in Dodge Motor Company resulted in a public outcry. In response, the Exchange announced that it would consider voting control when making listing decisions, and in 1940 the NYSE announced a flat policy against nonvoting common stock. Prior to these events, restrictions on shareholder voting rights were more common. *See* Stephen Bainbridge, ProfessorBainbridge.com, *Understanding Dual Class Stock Part I: An Historical Perspective* (September 9, 2017). Then again, prior to these events, the Securities and Exchange Commission did not exist.

[4] Stephen M. Bainbridge, Comments to the Securities and Exchange Commission on No. 4-537: *The Scope of the SEC's Authority Over Shareholder Voting Rights* (May 7, 2007).

[5] The SEC, led at the time by Chairman Arthur Levitt, attempted to intervene—but was thwarted by a controversial ruling of the D.C. Circuit. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[6] Wall Street Journal Business Blog: The Big Number, Wall. St. J. (Aug. 17, 2015).

[7] These trends are consistent with those noted by an insightful preliminary report by the Investor as Owner Subcommittee of the SEC's Investor Advisory Committee. *See* SEC, Investor Advisory Committee, *Discussion Draft: Dual Class and Other Entrenching Governance Structures in Public Companies* (December 17, 2017).

[8] *See, e.g.*, Alphabet Investor Relations, 2011 Founders' Letter ("In our experience, success is more likely if you concentrate on the long term. . . . For example, it took over three years just to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass.").

managers are at the mercy of daily stock-market pressure, dual-class can help America's most innovative companies create the sustainable long-term value we need to grow our economy.[9]

Many have argued forcefully, however, that one-share, one-vote should be the rule for all public corporations.[10] Whatever the benefits may be of permitting dual-class in a few well-known cases, these advocates argue, the costs for investors—who are left with no way to hold management's feet to the fire while dual-class is in place—outweigh those benefits.

But the question I want to ask today is not whether dual-class ownership is *always* good or bad. It's whether dual-class structures, once adopted, should last forever. Do Main Street investors in our public markets benefit when corporate insiders maintain outsized control *in perpetuity*?

This is not an academic exercise. You see, nearly half of the companies who went public with dual-class over the last 15 years gave corporate insiders outsized voting rights in perpetuity. Those companies are asking shareholders to trust management's business judgment—not just for five years, or 10 years, or even 50 years. *Forever*.

Corporate Royalty and Our Values

So perpetual dual-class ownership—forever shares—don't just ask investors to trust a visionary founder. It asks them to trust that founder's kids. And their kids' kids. And their *grandkid's* kids. (Some of whom may, or may not, be visionaries.) It raises the prospect that control over our public companies, and ultimately of Main Street's retirement savings, will be forever held by a small, elite group of corporate insiders—who will pass that power down to their heirs.

I cannot see how to square that with our nation's foundational ideas.[11] In America, we don't inherit power, and we don't hold power forever. We fought a war against that system, and the good guys won. That's why, following Thomas Jefferson's lead in Virginia, after Independence, state governments "laid axe to the root of pseudo-aristocracy," as Jefferson put it, by abolishing the laws of entail and primogeniture.[12] It's why our Constitution gives our legislature the broad authority to promote the general welfare, but carefully enumerated what Congress *cannot* do: grant titles of nobility.[13] It's why our founders rejected a permanent dual-class legislature: a House of Lords for the royalty and a House of Commons for Main Street.[14]

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[9] *See, e.g.*, Sens. Elizabeth Warren & Joe Donnelly, ***Trump's SEC Chairman Must Look Out for American** Families, Not Big Corporations*, Wash. Post. (March 22, 2017) ("[S]hortsighted corporations [are]chasing quick profits at the expense of their workers and the long-term health of their companies."

[10] *See, e.g.*, Council of Institutional Investors: Dual-Class Stock (Jan. 2018), *at* http://www.cii.org/dualclass_stock ("CII continues to view one-share equal voting rights upon IPO as the optimal approach.").

[11] Many prominent dual-class companies and their managers seem to understand this problem and have addressed the concern. *See, e.g.*, Sujeet Indap, *Dual-Class Shares Should Build in Expiration Plan*, Fin. Times (October 26, 2017).

[12] The Elusive Thomas Jefferson: The Man Behind the Myths 38 (M. Andrew Holowchak & Brian W. Dotts eds., 2012) (quoting an early letter from Jefferson to John Adams).

[13] U.S. Const. art. I § 9, cl. 8 ("No Title of Nobility shall be granted by the United States: And no Person holding any Office or Profit of Public Trust under them, shall, without the Consent of the Congress, accept any present, Emolument, Office, or Title, of any kind whatever, from any King, Prince, or foreign State.").

[14] Publius, The Federalist No. 63 (B. Wright ed., 1961) (arguing, by dint of comparison between the proposed Senate and the British House of Lords, that the former was not, and was unlikely to become, "[]confined to particular families and fortunes[or]an hereditary assembly of opulent nobles.").

Now, our public markets aren't our government, but our country's spirit of democratic accountability has long animated how we think about economics. That's why Adam Smith worried in his early writings about how economic models could account for the possibility that power could be wielded by royalty from beyond the grave.[15] And that's why today we require companies to give investors regular updates on their performance. If you run a public company in America, you're supposed to be held accountable for your work—maybe not today, maybe not tomorrow, but someday.[16]

So one problem with perpetual dual-class is it removes entrenched managers—and their kids, and their kids' kids—from the discipline of the market forever. Simply put: asking investors to put eternal trust in corporate royalty is antithetical to our values as Americans.[17]

Perpetual Dual-Class Stock and Corporate Performance

It's not just that perpetual dual-class stock ownership is disconcerting in principle. The data suggest that it is troubling in practice. And I know this because my staff and I ran the numbers. More on that in a moment.

But let's start with what existing research in this area can already tell us. One recent study shows that the costs and benefits of dual-class structures evolve over a company's lifetime.[18] Shortly after the IPO, dual-class firms trade at a premium—but, as the company matures, this premium eventually disappears. Early in a company's life, then, giving control to the firm's visionary founders makes sense—but at some point that structure is no longer beneficial.

For that reason, some argue that dual-class firms should include some limit on the amount of time before ordinary shareholders can weigh in on whether dual-class still makes sense for the company.[19] Whether a fixed term of years or upon a founder's passing, at that point, sometimes called a "sunset," shareholders get to have their say.

To explore these questions, my staff and I took a close look at 157 dual-class IPOs that have occurred over the past 15 years. We immediately noticed some pretty significant differences between the 71 dual-class companies with sunset provisions and the 86 who gave insiders control forever. Our regression models predicted relatively similar valuations at their IPO dates, a trend that continued for two years after the IPO. But over time, their predicted valuations diverged:

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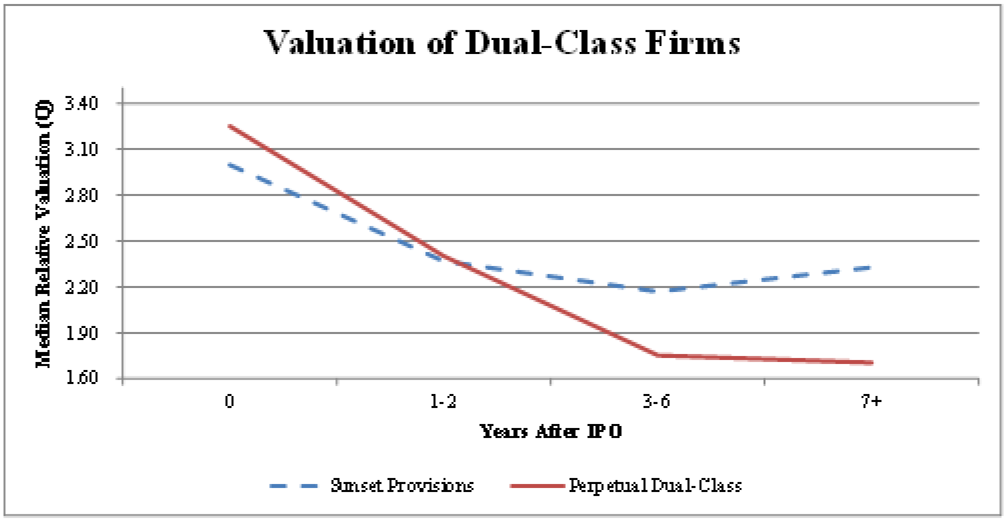
[15] Samuel Fleischacker, On Adam Smith's "Wealth of Nations": A Philosophical Companion (2014) (quoting Smith's lectures on jurisprudence).

[16] Casablanca, Dir. Michael Curtiz (Warner Bros. 1942).

[17] The idea that concentrated corporate power is held in just a few individuals' hands and will be passed down to their heirs is made all the more troubling by the fact that so few corporations today wield so much influence over so many American lives. I wonder how many of the problems plaguing our securities markets today can and should be treated by that old, familiar, and uniquely American medicine: competition.

[18] Martijn Cremers, Beni Lauterbach, and Anete Pajuste, *The Life-Cycle of Dual-Class Firms* (Jan. 1, 2018), *at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895.

[19] Lucian Bebchuk & Kobi Kastiel, *The Untenable Case for Dual-Class Stock*, 103 Va. L. Rev. 585 (2017).



Seven or more years out from their IPOs, firms with perpetual dual-class stock trade at a significant discount[20] to those with sunset provisions.[21] We also found that, among the small subset of firms that decided to drop their dual-class structures later in their life cycles, those decisions were associated with a significant increase in valuations.[22] To be sure, our analysis is preliminary, and this is a subject that deserves much further study. In the spirit of a robust debate, I am making public the results of our analysis as well as our underlying data and assumptions.[23]

The Path Ahead

I'm not the only one concerned about dual-class stock and its effects on our markets. Investors have loudly and clearly registered their objections to this structure, both through the SEC's Investor Advisory Committee and the Council of Institutional Investors.[24]

As a result of that engagement, three major providers have moved to exclude dual-class companies from significant stock indexes. FTSE Russell will exclude all companies whose free

[20] For our principal analysis we assess value with a much-maligned measure of corporate performance: Tobin's Q. Important recent work, however, has shown the danger in relying exclusively on Tobin's Q for purposes like these. *See* Robert P. Bartlett & Frank Partnoy, *The Misuse of Tobin's Q* (February 4, 2018); *see also* Emiliano Catan & Michael Klausner, *Board Declassifications and Firm Value: Have Shareholders Really Destroyed Billions in Value?* (October 10, 2017). So we re-ran our analysis using monthly equal-weighted portfolio returns for the perpetual sample versus the sunset sample. We did this in both calendar time and then, separately, in event time, with each firm's life cycle starting at zero and proceeding for 48 months. We then constructed a long-short cumulative return for the difference between the two portfolios, and the results are very consistent with those described above.

[21] One might ask why we compare firms with perpetual dual-class to those with dual-class sunset provisions rather than firms with a single class of stock. We do this because we, like scholars in the area, worry that any attempt to match perpetual dual-class firms with single-class firms will omit important differences that cannot be adequately controlled for. *See* Cremers, Lauterbach, and Pajuste, *supra.* Since our sample includes only dual-class firms, we avoid the possibility that underlying differences between single-class and dual-class firms drive our results.

[22] This evidence does not, of course, establish that perpetual dual-class structures *cause* firms to suffer lower valuations. It may be, for example, that the causal arrow runs the other way: that firms anticipating that they will be worth less later in their life cycle select perpetual dual class structures. Either way, the evidence suggests that this governance structure is associated with lower firm value. These data make it unsurprising that investors have expressed such significant concern about the use of dual class.

[23] I could bore you with the details of our regressions, fixed effects, and clustered standard errors, but I know that's not what you came to hear about. Instead, I'll point the interested listener to the data appendix to this speech, where you can learn more about our methodology and analysis. I hope that this first step will help bring increased academic interest to dual-class stock—and the ongoing debate about its costs and benefits for investors.

[24] *See* Investor Advisory Committee, *supra*; Council of Institutional Investors, *supra*.

float constitutes less than 5% of total voting power;[25] S&P Dow Jones will, going forward, exclude *all* dual-class firms;[26] and MSCI will reduce the weight that dual-class firms occupy in its indexes.[27]

Investors, facing a wave of companies using dual-class to insulate their managers from accountability, have every right to bring those complaints to index providers. And there's no doubt about it: the indices' decisions sent a loud message to the markets.[28] But excluding all dual-class firms from our major market indices is a blunt tool. And it's one I'm deeply worried about.

Let me explain why. We face a growing gap in this country between our markets and Main Street investors. The middle class watches our markets rise and increasingly—and correctly—senses that they are left out, that the benefits of that growth are accruing to someone else. And middle class investors often own stock in American public companies through an index. Though their holdings may be small, those holdings reflect their participation in our economic future.[29]

If we ban all dual-class companies from our major indices, Main Street investors may lose out on the chance to be a part of the growth of our most innovative companies. The next Google or the next Facebook will deliver spectacular returns, but average Americans will, quite literally, not be invested in their growth. No one here in Silicon Valley should want to leave average Americans out of their growth story. And investors should not be forced to choose being long American innovation and signing up for corporate royalty.

That's why I hope that our national securities exchanges will soon consider proposed listing standards addressing the use of perpetual dual-class stock. Such standards would allow Main Street investors to share in our economy's growth—but avoid asking them to trust corporate management forever. Companies would still be able to IPO with dual-class voting arrangements—but only if management is willing to someday give shareholders their say.[30] And while cynics may say that companies will flee abroad to list, I think it's pretty unlikely that we'll see a mass exodus of listings away from the deepest, most liquid capital markets in the world just so founders' children can inherit and run America's public companies.

* * *

While it is fair to ask people to place their eternal trust in their partner, our country's founding principles and our corporate law counsel against the creation of corporate royalty. The solution to

[25] FTSE Russell, FTSE Russell Voting Rights Consultation: Next Steps (July 2017), *available at* http://www.ftse.com/products/downloads/FTSE_Russell_Voting_Rights_Consultation_Next_Steps.pdf.

[26] S&P Dow Jones Indices, Decision on Multi-Class Shares and Voting Rights (July 2017), *available at* https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulti-classsharesandvotingrulesannouncement7.31.17.pdf?force_download=true.

[27] MSCI, Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes (January 2018), *at* https://www.msci.com/documents/1296102/8328554/Consultation__Voting+Rights.pdf.

[28] *See, e.g.*, Matt Levine, *Listing Standards and Dividend Shares*, Bloomberg View: Money Stuff (April 13, 2017) (arguing that excluding firms on the basis of governance characteristics is a "weird role" for stock indices, and pointing to the "long tradition of corporate governance standards being imposed by stock exchanges as 'listing standards,' a sort of seal of approval.

[29] Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* (November 2017, NBER Working Paper No. 24085).

[30] Some may argue that, since investors can price the effects of perpetual dual-class at the IPO stage, there is no need for such standards. I am unconvinced that the IPO markets we have today reflect the kind of efficiency that argument demands. In any event, exchange standards need not require dual-class to end—just that shareholders get to vote on the structure. If managers can convince the markets of their merits, they'll be free to retain dual-class.

that problem is not to leave ordinary Americans out of the growth that all of you here in Silicon Valley are creating. The solution is to return to the tradition of accountability that has served our nation and our markets so well.

As a Commissioner, my job is to pursue a three-part mission at the SEC: protect investors, maintain fair and efficient markets, and facilitate capital formation. All three would be advanced if the exchanges promptly pursue this issue. By giving investors more say in the governance of their companies, we can help protect them from managers who would misuse dual-class to extract value rather than build it. By providing clear rules of the game for both shareholders and management, we help them understand and price the risks they're taking. And by giving visionary founders the space to control their companies soon after their IPO, we encourage them to use our public markets—and share their growth with Main Street investors.

The exact form that exchange standards might take—and the best way to "sunset," or limit, dual-class structures—is beyond the scope of my talk today. And besides, I have no doubt that the folks in this room can come up with innovative ways to solve that problem.[31] I know that all of you share my goal of finding a way to allow today's visionaries to access our public markets in a way consistent with our values. And I urge you all to get to work, alongside our exchanges, to make sure that Main Street investors share in the future you're shaping here every day.

* * *

The complete publication, including footnotes, is available here.

[31] For innovative proposals in this respect, *see* Bebchuk & Kastiel, *supra*, at 619-628.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

The Untenable Case for Perpetual Dual-Class Stock

Posted by Lucian Bebchuk and Kobi Kastiel, Harvard Law School, on Monday, April 24, 2017

Editor's note: Lucian Bebchuk is the James Barr Ames Professor of Law, Economics, and Finance, and Director of the Program on Corporate Governance, at Harvard Law School. Kobi Kastiel is the Research Director of the Project on Controlling Shareholders of the Program. This post is based on their Article, The Untenable Case for Perpetual Dual-Class Stock, forthcoming in the *University of Virginia Law Review*. The Article is part of the research undertaken by the Project on Controlling Shareholders.

We recently placed on SSRN our study, The Untenable Case for Perpetual Dual-Class Stock. The study, which will be published by the *University of Virginia Law Review* in June 2017, analyzes the substantial costs and governance risks posed by companies that go public with a long-term dual-class structure.

The long-standing debate on dual-class structure has focused on whether dual-class stock is an efficient capital structure that should be permitted at the time of initial public offering ("IPO"). By contrast, we focus on how the passage of time since the IPO can be expected to affect the efficiency of such a structure.

Our analysis demonstrates that the potential advantages of dual-class structures (such as those resulting from founders' superior leadership skills) tend to recede, and the potential costs tend to rise, as time passes from the IPO. Furthermore, we show that controllers have perverse incentives to retain dual-class structures even when those structures become inefficient over time. Accordingly, even those who believe that dual-class structures are in many cases efficient at the time of the IPO should recognize the substantial risk that their efficiency may decline and disappear over time. Going forward, the debate should focus on the permissibility of finite-term dual-class structures—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller.

We provide a framework for designing dual-class sunsets and address potential objections to their use. We also discuss the significant implications of our analysis for public officials, institutional investors, and researchers.

Below is a more detailed summary of our analysis:

1990, Viacom Inc., a prominent media company, adopted a dual-class capital structure, consisting of two classes of shares with differential voting rights. This structure enabled Viacom's controlling shareholder, Sumner Redstone, to maintain full control over the company while holding only a small fraction of its equity capital. At the time, Redstone was already one of the most powerful and successful figures in Hollywood. Indeed, three years earlier, he had bought

Viacom in a hostile takeover, exhibiting the kind of savvy and daring business maneuvers that subsequently helped him transform Viacom into a $40 billion entertainment empire that encompasses the Paramount movie studio and the CBS, MTV, and Showtime television networks. Investors during the 1990s could have reasonably been expected to be content with having Redstone safely at the helm.

Fast-forward twenty-six years to 2016: Ninety-three-year-old Redstone faced a lawsuit, brought by Viacom's former CEO and a long-time company director, alleging that Redstone suffered from "profound physical and mental illness"; "has not been seen publicly for nearly a year[;] can no longer stand, walk, read, write or speak coherently; … cannot swallow[;] and requires a feeding tube to eat and drink." Indeed, in a deposition, Redstone did not respond when asked his original family birth name. Some observers expressed concerns that "the company has been operating in limbo since the controversy erupted." However, public investors, who own approximately ninety percent of Viacom's equity capital, remained powerless and without influence over the company or the battle for its control.

Eventually, in August 2016, the parties reached a settlement agreement that ended their messy legal battles, providing Viacom's former CEO with significant private benefits and leaving control in the hands of Redstone. Notably, despite the allegation and the evidence that surfaced, the settlement prevented a court ruling on whether Redstone was legally competent. Note that even a finding of legal competency would have hardly reassured public investors: Legal competence does not by itself qualify a person to make key decisions for a major company. Moreover, once Redstone passes away or is declared to be legally incompetent, legal arrangements in place would require the control stake to remain for decades in an irrevocable trust that would be managed by a group of trustees, most of whom have no proven business experience in leading large public companies. Thus, even assuming that Viacom's governance structure was fully acceptable to public investors two decades ago, this structure has clearly become highly problematic for them.

Let us now turn from Viacom to Snap Inc. The company responsible for the popular disappearing-message application Snapchat has recently gone public with a multiple-class structure that would enable the company's co-founders, Evan Spiegel and Robert Murphy, to have lifetime control over Snap. Given that they are now only twenty-six and twenty-eight years old, respectively, the co-founders can be expected to remain in control for a period that may last fifty or more years.

Public investors may be content with having Spiegel and Murphy securely at the helm in the years following Snap's initial public offering. After all, Spiegel and Murphy might be viewed by investors as responsible for the creation and success of a company that went public at a valuation of nearly $24 billion. However, even if the Snap co-founders have unique talents and vision that make them by far the best individuals to lead the company in 2017 and the subsequent several years, it is hardly certain that they would continue to be fitting leaders down the road. The tech environment is highly dynamic, with disruptive innovations and a quick pace of change, and once-successful founders could well lose their golden touch after many years of leading their companies. Thus, an individual who is an excellent leader in 2017 might become an ill-fitting or even disastrous choice for making key decisions in 2037, 2047, or 2057. Accordingly, as the time since Snap's IPO grows, so does the risk that Snap's capital structure, and the co-founders' resulting lock on control, will generate costly governance problems.

The examples of Viacom and Snap highlight an important dimension—the passage of time since a company's IPO—that has thus far received insufficient attention. This Article seeks to provide a comprehensive, systematic analysis of how the potential costs and benefits of a dual-class structure—and thus the overall efficiency of such a structure—change over time. Our analysis demonstrates that, as time passes, the potential costs of a dual-class structure tend to increase and the potential benefits tend to erode. As a result, even if the structure were efficient at the time of the IPO, there would be a substantial risk that it would not remain so many years later, and this risk would keep increasing as time passes. Furthermore, we show that controllers have strong incentives to retain a dual-class structure even when that structure becomes inefficient over time. Thus, even those who believe that a dual-class structure is often efficient at the time of the IPO should recognize the perils of providing founders with perpetual or even lifetime control.

The debate going forward should focus on the assessment and permissibility of dual-class structures with a finite term—that is, structures that sunset after a fixed period of time (such as ten or fifteen years) unless their extension is approved by shareholders unaffiliated with the controller. We examine how sunsets could be designed, address potential objections to their use, and explain the implications of our analysis for public officials, institutional investors, and corporate governance researchers.

The analysis of our Article is organized as follows. Part I explains the substantial stakes in the policy debate that we seek to reframe. We begin by discussing the importance of dual-class companies in the United States and around the world. A significant number of U.S. public companies, including such well-known companies as CBS, Comcast, Facebook, Ford, Google, News Corp., and Nike, have dual-class structures. Furthermore, since Google decided to use a dual-class structure for its 2004 IPO, a significant number of "hot" tech companies have followed its lead.

Part I also discusses the long-standing debate over the desirability of dual-class structures. The New York Stock Exchange ("NYSE") prohibited dual-class structures for approximately sixty years, until the mid-1980s, and they are still prohibited or rare in some jurisdictions, such as the United Kingdom and Hong Kong. However, the rules now prevailing in the United States, as well as in some other jurisdictions around the world, permit the use of dual-class stock. Moreover, the debate on the subject is still ongoing—both in jurisdictions that prohibit dual-class structures and those that permit them.

In this debate, which has thus far focused on whether and when it is desirable for companies to go public with a dual-class structure, we side with those who are skeptical of the value of dual-class IPOs. In this Article, however, we seek to reorient the debate by focusing on the mid-stream desirability of dual-class structures in long-standing public companies. Showing that dual-class structures are likely to become inefficient over time even if they happen to be efficient at the time of the IPO, we suggest taking one option—a perpetual dual-class structure—off the table. Going forward, the debate should focus on whether companies should be allowed to go public with finite-life dual-class structures—that is, structures with a sunset clause. Perpetual dual-class stock, without any time limitation, should not be part of the menu of options.

Part II analyzes how the potential costs of dual-class structures change over time. These costs tend to increase for two major reasons. To begin, in a dynamic business environment, even a founder who was the fittest leader at the time of the IPO might eventually become an inferior leader due to aging or changes in the business environment, and this risk increases the expected costs of providing the founder with a lifetime lock on control. Indeed, the expected costs of a lifetime lock on control are likely to be especially large when the founder is young or even middle-aged at the time of the IPO. Concerns about the emergence of inferior leadership over time are further aggravated when the dual-class structure enables a transfer of the founder's lock on control to an heir who might be unfit to lead the company.

Furthermore, many dual-class structures enable controllers to substantially reduce their fraction of equity capital over time without relinquishing control, and controllers often do so to diversify their holdings or finance other investments or assets. When the wedge between the interests of the controller and those of the public investors grows over time, the agency costs of a dual-class structure can also be expected to increase.

Part III then analyzes how the potential benefits of a dual-class structure can be expected to change over time. Dual-class structures are often justified on the grounds that the founder of a company going public has skills, abilities, or vision that makes her uniquely fit to be at the helm. Many years later, however, the founder's superiority as the company's leader, and with it the expected value of having the founder retain a lock on control, could erode or disappear altogether. Another potential benefit often ascribed to dual-class structures is that they insulate management from short-term market pressures. However, the expected benefit from such insulation is likely to be larger when the controller is a fitting leader for the company and likely to decline when the passage of time makes the controller ill fitting for the leadership role. Finally, it might be suggested that insulation from market forces might be beneficial to companies that are new to the public market, but any such potential benefit is again expected to decline and eventually disappear as time passes from the IPO.

Part IV explains why public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time. We show that controlling shareholders, especially those who hold a small fraction of equity capital, have significant perverse incentives to retain a dual-class structure that has become inefficient, even when dismantling it—via a conversion to a one-share-one-vote structure or a sale of the company—would produce substantial efficiency gains. The reason is that the controller would capture only a fraction of the efficiency gains, which would be shared by all shareholders, but would fully bear the cost of forgoing the private benefits of control associated with the dual-class structure.

To address the distorted incentives of controllers to retain dual-class structures even when those structures become substantially inefficient, IPO dual-class structures can include sunset provisions stipulating the structures' expiration after a fixed period of time, such as ten or fifteen years. Part V discusses the merits and design of such sunset provisions. To enable the retention of structures that remain efficient, we explain that the initially specified duration of the dual-class structure could be extended if such extension is approved by a majority of the shareholders unaffiliated with the controller. We also address potential objections to arrangements that preclude or discourage perpetual dual-class structures. In particular, we respond to objections that (1) perpetual dual-class structures should be presumed efficient if they are chosen by market participants and (2) allowing perpetual structures is necessary to induce founders to go public.

Finally, Part VI discusses the implications of our analysis for policymaking, investors, and corporate-governance research. Public officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure. They should also be attentive to the aggravated agency problems that are posed by companies that went public with perpetual dual-class structures a long time ago. Researchers should take the time dimension into account in their analyses of dual-class structure and should test several empirical predictions that Part VI puts forward. We hope that future assessments of dual-class structures will be informed by the problems that we identify in this Article and the framework of analysis that we put forth.

The Article is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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The Perils of Small-Minority Controllers

Posted by Lucian A. Bebchuk, Harvard Law School and Kobi Kastiel, Harvard Law School, on Monday, February 26, 2018

Editor's note: Lucian Bebchuk is James Barr Ames Professor of Law, Economics and Finance, and Director of the Corporate Governance Program, at Harvard Law School. Kobi Kastiel is Research Director of the Program's Project on Controlling Shareholders and Assistant Professor at Tel-Aviv University Faculty of Law. This post is based on their recent study, available here.

Dropbox filed IPO documents last week, and our analysis of these documents reveals considerable risk that the company's co-founders would hold lifetime control even if they would retain only a tiny minority of the company's equity capital. In a study that we just placed on SSRN, The Perils of Small-Minority Controllers, we seek to place a spotlight on a significant set of dual-class companies whose structures raise especially severe governance concerns: those with controllers holding a small minority of the company's equity capital.

We analyze the perils of small-minority controllers, explaining how they generate considerable governance costs and risks and showing how these costs can be expected to escalate as the controller's stake decreases. We also identify the mechanisms that enable such controllers to retain their power despite holding a small or even a tiny minority of the company's equity capital. Based on a hand-collected analysis of governance documents of these companies, we present novel empirical evidence on the current incidence and potential growth of small-minority and tiny-minority controllers. Among other things, we show that governance arrangements at a substantial majority of dual-class companies enable the controller to reduce his equity stake to below 10% and still retain a lock on control, and a sizable fraction of such companies enable retaining control with less than a 5% stake.

Finally, we examine the considerable policy implications that arise from recognizing the perils of small-minority controllers. We first discuss disclosures necessary to make transparent to investors the extent to which arrangements enable controllers to reduce their stake without forgoing control. We then identify and examine measures that public officials or institutional investors could take to ensure that controllers maintain a minimum fraction of equity capital; to provide public investors with extra protections in the presence of small-minority controllers; or to screen midstream changes that can introduce or increase the costs of small-minority controllers.

Below we provide a more detailed account of our analysis:

Snap, the owner of the disappearing-message application Snapchat, went public last March at a valuation exceeding $20 billion. The company used a multiple-class structure that would enable its young co-founders, Evan Spiegel and Bobby Murphy, to have lifetime control of the company.

Following the initial public offering, Spiegel and Murphy owned a substantial fraction of Snap's equity capital—about 18% each. Our analysis of Snap's IPO structure indicates that it would enable the co-founders to unload an overwhelming majority of their shares—lowering their economic stakes to less than 1% of the company's equity capital—and still retain control. Notably, however, Snap's offering documents omitted this crucial fact.

Similarly, Facebook, Snap's larger and older rival, went public in 2012 with a dual-class structure that placed significant limits on the ability of its founder, Mark Zuckerberg, to reduce his fraction of equity capital without relinquishing control. In April 2016, however, Facebook passed a reclassification plan, approved by Zuckerberg's majority voting power, that would have enabled Zuckerberg to sell two-thirds of his Facebook shares—reducing his stake of equity capital to about 4% and possibly less—without losing his controlling voting power. In September 2017, however, Facebook announced its decision not to proceed with the reclassification plan for the time being, and Zuckerberg currently continues to face significant limits on his freedom to unload shares without losing his control.

In our paper, we focus on such situations — dual-class structures that enable controllers to have a lock on control with only a small or even a tiny fraction of the company's equity capital. In the long-standing debate on dual-class structures, both proponents and opponents have often lumped all dual-class structures together into one category. By contrast, we seek to reorient the debate by stressing certain key differences among dual-class structures.

Dual-class structures generally enable a shareholder to retain a lock on control with less than a majority ownership stake. Dual-class structures thus commonly enable what the literature labels as a "controlling minority shareholder" (Bebchuk-Kraakman-Triantis (2000)). In our paper, however, we focus on the subset of controlling minority shareholders whose stake is not merely a minority stake, but rather a "small-minority" stake (defined as below 15% of equity capital), a "very-small-minority" stake (below 10%) or even a "tiny-minority" stake (below 5%). Controllers holding such stakes pose enhanced governance risks relative to other controlling minority shareholders, and therefore they deserve the close attention of public officials and institutional investors.

The analysis of our paper is organized as follows. Part II begins by discussing the long-standing and heated debate over dual-class structures and how we aim at contributing to it and reorienting it. We then turn to explain why structures with small-minority controllers can be expected to produce considerable governance risks and costs. In companies that are widely held, the market for corporate control and the threat of replacement incentivizes corporate insiders to serve the interests of public investors. In companies with a majority owner, the disciplinary force of the control market does not operate, but the controller's ownership stake forces the controller to bear the majority of the effect of his choices on total market capitalization, and thus provides strong ownership incentives that align the controller's interests with those of public investors. By contrast, a company with a small-minority controller lacks both the discipline of the control market and the incentives generated by having to bear a majority of any effect on total market capitalization.

We show how the decisions made by small-minority controllers can be expected to be distorted across a wide range of corporate choices—including allocation of opportunities and talents, decisions whether to remain as the CEO, choices of strategy and company scale, related-party-transactions, and responses to acquisition offers. In each of these contexts, we show, there is a substantial risk that the choices of small-minority controllers would be significantly distorted.

Part III of our paper identifies and explains the operation of mechanisms that are used to enable shareholders to retain control despite owning only a small minority of the company's equity capital. Furthermore, using a hand-collected dataset of governance arrangements in dual-class companies, we provide empirical evidence about the incidence and use of these mechanisms.

The mechanisms that Part III analyzes include (i) "hardwiring" provisions granting the controller the ability to elect a majority of board members, or to cast a fixed fraction of votes, regardless of how small the controller's equity stake might become; (ii) a large difference between the voting power of high-vote and low-vote shares; (iii) nonvoting shares, which represent an extreme case of infinitely high ratio between the voting power of high-vote and low-vote shares; (iv) arrangements aimed at limiting the consequences that stock sales by the controller could have for the controller's lock on power; and (v) arrangements aimed at constraining the consequences that high-voting shares held by third parties could have on the controller's lock on power.

Part III also analyzes midstream changes, such as nonvoting stock reclassifications, that can be used to amend existing governance arrangements to enhance the controller's ability to unload shares without relinquishing control. We show that the future use of such nonvoting stock reclassification could enable controllers to reduce their ownership stakes to negligible levels without weakening their grip on control.

Part IV presents novel empirical evidence, based on our hand-collected dataset of governance provisions in dual-class structures, on the incidence of small-minority, very-small-minority, and tiny-minority controllers. Importantly, we analyze not only current equity stakes but also the extent to which controllers would be able to reduce their equity stakes in the future without relinquishing control. Existing governance provisions plant the seeds for future increases in the separation between control and ownership stake, so we also analyze the minimum equity stake that the controller at each company would need to hold to retain control.

We find that, in a *sizable fraction* of cases, the governance provisions in place would enable the controller to hold less than 5% of the equity capital (and thus be a "tiny-minority controller") and still retain control. Furthermore, in a *substantial majority* of cases, the governance provisions in place would enable the controller to hold less than 10% of the equity capital (and thus be a "very-small-minority") and still retain control. Finally, in an *overwhelming majority*, the governance provisions in place would enable the controller to hold less than 15% of the equity capital (and thus be a "small-minority controller") and still retain control.

Part V discusses the implications of our analysis for future policymaking and capital market practices. To begin, public officials and institutional investors should recognize the substantial governance risks associated with small-minority controllers. The extent to which governance arrangements can be used to expand the "wedge" ¾ the gap between the controller's fraction of voting rights and his fraction of equity capital ¾ is commonly not transparent to investors. Thus, disclosure rules should require companies to provide such information. In assessing the extent to which dual-class companies pose governance risks, public officials and institutional investors should play close attention to the existing and potential level of the wedge.

Furthermore, we identify and discuss arrangements that could be used to address the current and future presence of small-minority controllers. Institutional investors could press for or encourage the introduction of such measures, and public officials could consider using their legal and regulatory tools to ensure a uniform adoption of such measures. Here we discuss three types of arrangements: (i) arrangements aimed at limiting the extent to which controllers can lower their ownership stake without weakening their lock on control; (ii) arrangements aimed at providing additional protections to public investors in situations where small-minority controllers would remain in control; and (iii) arrangements aimed at preventing midstream changes, such as nonvoting stock reclassifications, that would introduce or exacerbate the governance costs of small-minority controllers.

Before proceeding, we should note that some corporate law scholars oppose any limits on the structures that companies going public may offer to investors. The debate on contractual freedom in corporate law is long-standing and raises general questions that go beyond the scope of this paper. While we subscribe to the view that it is desirable to place some constrain on IPO choices, as existing corporate and securities law do, this paper does not seek to repeat the arguments for this view or otherwise to contribute to the debate on contractual freedom. However, because we recognize that some readers could well support in principle allowing companies to go public with any structures they choose, we wish to stress that our analysis should be of interest even to such readers.

To be sure, such readers would not support requiring dual-class companies to adopt governance provisions that place any limit on the size of the stake that controllers would be required to have to retain control. However, the main contribution of our paper, and one which should be of interest even to such readers, is to provide an understanding of the governance risks posed by small-minority controllers. To the extent that such risks are significant, even such readers should recognize the benefits to public officials and institutional investors of understanding these risks. Obtaining such an understanding would be essential for facilitating the introduction of private-ordering arrangements that would serve the interests of public investors; for judicial application of an appropriate level of scrutiny to controller actions; and for the development of disclosures that would provide adequate transparency of the risks posed to public investors and would help IPO investors to price these arrangements accurately.

Our paper is available for download here.

Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Dual-Class Stock and Private Ordering: A System That Works

Posted by David J. Berger, Wilson Sonsini Goodrich & Rosati, on Wednesday, May 24, 2017

Editor's note: David J. Berger is Partner at Wilson Sonsini Goodrich & Rosati. This post is based on a Wilson Sonsini publication by Mr. Berger, Steven E. Bochner, and Larry Sonsini. Related research from the Program on Corporate Governance includes The Untenable Case for Perpetual Dual-Class Stock by Lucian Bebchuk and Kobi Kastiel (discussed on the Forum here).

Dual-class stock has become the target of heightened attention, particularly in light of Snap's recent IPO. While the structure remains popular for companies trying to respond to the short-term outlook of public markets—including companies in the technology and media sectors, as well as companies in more traditional industries ranging from shipping and transportation to oil and gas, and everything in between—dual-class stock continues to be the subject of considerable attack by various investor groups and some academics. Further, while a majority of dual-class companies are not technology companies, young technology companies continue to be the primary focus of governance activists.[1]

Despite the controversy over dual-class stock, we believe that the present system of private ordering with respect to dual-class stock will—*and should*—continue. Private ordering allows boards, investors, and other corporate stakeholders to determine the most appropriate capital structure for a particular company, given its specific needs. So long as the company makes appropriate disclosure of its capital structure, including the implications of this structure to its investors, we believe there is no need for further regulation on this issue.

The benefits of a system of private ordering have become increasingly apparent in the U.S. and across the globe. For example, both Nasdaq and the NYSE continue to actively solicit and list companies with multi-classes of stock. According to a recent Council of Institutional Investors (CII) study, about 10 percent of publicly listed companies have multi-class structures. This includes not just newly public and/or prominent technology companies such as Alphabet (formerly Google), Facebook, and Snap, or even numerous media companies such as CBS, Liberty Media, Sinclair Broadcast Group, Scripps, and Viacom, but also companies in every industry ranging from financial services (Berkshire Hathaway, Evercore, Houlihan Lokey, etc.) to consumer products (Constellation Brands, Coca-Cola Bottling Co., Nike, Panera Bread, etc.) to transportation and industrial companies (Swift Transportation, TerraForm, Quaker Chemical, Nacco Industries, etc.).

[1] The Council of Institutional Investors recently published a list of dual-class companies in the Russell 3000. The list can be found here: http://www.cii.org/files/3_17_17_List_of_DC_for_Website(1).pdf.

As the companies identified above demonstrate, many of the dual- or multi-class companies listed by the NYSE and Nasdaq continue to be among the most successful in the world—both financially and from a governance perspective. The success and prominence of these companies make it unlikely that there will be a broad effort among the exchanges to require them to change their governance structure.

The success of many dual-class companies has also led both Nasdaq and the NYSE to continue to support dual-class listings. For example, Nasdaq recently released a report (discussed on the Forum here) that included an endorsement of dual-class stock, including laying out the arguments why companies with dual-class stock should continue to be listed.[2] Among the reasons cited by Nasdaq was the recognition that encouraging entrepreneurship and innovation in the U.S. economy is best done by "establishing multiple paths entrepreneurs can take to public markets." Because of this, each "publicly traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up front so that investors have complete visibility into the company. Dual-class structures allow investors to invest side-by-side with innovators and high-growth companies, enjoying the financial benefits of these companies' success.[3]" While the NYSE has not recently issued any public statements on multi-class stock, it continues to actively seek to list companies with multi-class stock, including Alibaba, which chose to list on the NYSE after the Hong Kong stock exchange raised significant questions about its governance structure.

The trend towards private ordering on dual-class shares can also be seen globally. For example, less than two years ago, Hong Kong's stock exchange rejected a proposal to allow companies with dual-class stock to list on its exchange. However, the Hong Kong Securities and Futures Commission (SFC) recently announced a new study to determine whether to permit dual-class listings (including possibly creating a separate exchange for companies listing dual-class stock). While the SFC's decision includes consideration of a new trading exchange in Hong Kong for companies with multi-class structures, its actions have been widely interpreted as essentially reversing its prior decision. Additionally, the SFC's chairman recently announced that the SFC "supports the consultation to allow the public to share their views on the dual-shareholding structure," and he made it clear that the SFC was "open minded" about the possibility of listing dual-class companies.

Singapore appears to be going through a similar transition. Singapore also historically did not allow listings of dual-class companies, but in February 2017, the country released a paper titled "Possible Listing Framework for Dual-Class Share Structures." The proposal has been the subject of considerable debate, with many large institutional investors (including those based in the U.S.) opposed to allowing any type of dual-class listing. At the same time, the head of Singapore's Investors Association, which represents more than 70,000 retail investors and is the largest organized investor group in Asia, has become an outspoken advocate of dual-class stock, arguing that "retail investors are not idiots" and that any "capital market that is aspiring to be leading" should offer this alternative.

The trend can also be seen in Europe. In 2007, the EU considered imposing a one-share/one-vote requirement on publicly traded companies, but abandoned the idea at the time of the 2008

[2] A copy of Nasdaq's Blueprint for Market Reform can be found here: http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf, discussed on the Forum here.

[3] *Id*. at 16.

financial crisis. Now many EU countries are adopting some form of "time-based voting" shares, to encourage long-term investors by giving more votes to shareholders who own their shares for longer periods.[4] For example, France has adopted the "Florange Act," which generally provides that shareholders who own their shares for two years will receive two votes per share. Italy has also considered loyalty shares, while in many of the Nordic countries companies with shares with multiple voting rights are common.[5]

At the same time, critics of dual-class stock in the U.S., especially within the institutional investor community, remain quite vocal. For example, the Securities and Exchange Commission's (SEC's) Investor Advisory Committee recently held a hearing on dual-class stock, where its use was sharply criticized by Commissioner Stein (whose term ends in June), as well as a representative from CII.[6] During the meeting, representatives from CII and other institutional investors urged the SEC to use its regulatory authority over the exchanges to limit the ability of companies to have dual-class structures, while also calling upon the companies that create the benchmark indexes to exclude companies with non-voting stock from these indexes (ironically, many of the same companies that create these indexes are CII members and among the world's largest institutional investors).

More recently, two of the country's leading academics, Harvard Law School professors Lucian Bebchuk and Kobi Kastiel, published an article (discussed on the Forum here) calling for a mandatory sunset provision on all dual-class stock for public companies.[7] The Bebchuk and Kastiel piece argues that "public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time," and for that reason "[p]ublic officials and institutional investors should consider precluding or discouraging IPOs that set a perpetual dual-class structure." Bebchuk and Kastiel conclude that "[p]erpetual dual-class stock, without any time limitation, should not be part of the menu of options" for public companies.

We disagree with Bebchuk and Kastiel on the need for additional regulation in this area and, further, do not believe that the SEC will adopt the Bebchuk and Kastiel proposal. While the SEC has not recently taken a formal position on dual-class stock, its new leadership is certainly familiar with the issue. For example, while Chairman Clayton was a partner at Sullivan & Cromwell, he represented many companies with dual-class share structures, and William Hinman, the SEC's new Director of Corporate Finance, represented Alibaba in its IPO. Mr. Hinman, who was based in Silicon Valley before taking his new position at the SEC, was also involved in a number of other IPOs where companies have dual-class stock. While it is impossible to predict the future positions of the SEC, Chairman Clayton has emphasized that one of his top priorities is to reverse the decline in U.S. public companies that has occurred over the last 20 years. As Nasdaq recognized, one way to foster increased numbers of IPOs (as well as

[4] For a lengthier discussion on time-based voting and its possibilities in the U.S., *see* David J. Berger, Steven Davidoff Solomon, and Aaron Jedidiah Benjamin, "Tenure Voting and the U.S. Public Company," 72 *Business Lawyer* 295 (2017).

[5] According to ISS, 64 percent of Swedish companies have two share classes with unequal votes, while 54 percent of French companies have shares entitled to double-voting rights. *See* "ISS Analysis: Differentiated Voting Rights in Europe" (2017), available at https://www.issgovernance.com/analysis-differentiated-voting-rights-in-europe/.

[6] WSGR partner David J. Berger was also a panelist at this forum, and explained why companies and investors may support dual-class shares (or at least allow for private ordering on this issue). A copy of Mr. Berger's remarks can be found here: https://www.sec.gov/spotlight/investor-advisory-committee-2012/berger-remarks-iac-030917.pdf.

[7] *See* Lucian Bebchuk and Kobi Kastiel, "The Untenable Case for Perpetual Dual-Class Stock," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2954630 (discussed on the Forum here).

companies staying public rather than going private) is by allowing companies (and entrepreneurs) the option of dual-class shares and other alternative capital structures.

We agree with Nasdaq and believe that dual-class stock is an issue that is best left to private ordering. For some companies, dual-class stock is both necessary and appropriate to respond to the corporate governance misalignment that exists in our capital markets today. In particular, many of the rules governing our capital markets have the practical impact of favoring short-term investors. When responding to this governance misalignment it is understandable that some companies may choose dual-class (or multi-class) stock. While multiple classes of stock are obviously not the right model for all companies (and it must be noted that there are many different types of capital structures even within the multi-class framework), there is no single capital structure that is right for all companies. Given the dynamics of our capital markets and the ever-changing needs of entrepreneurs and companies, a company's capital structure is best left to a company's investors and a system of private ordering based upon full disclosure.